The Southland Corporation 1986 Annual Report

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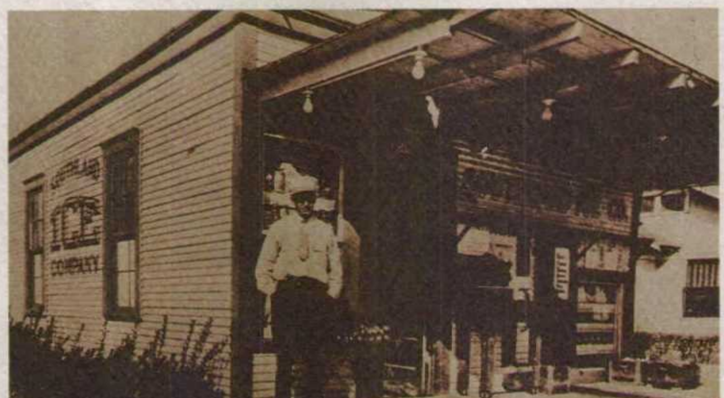
Southland and Citgo Facilities Inside Back Cover

About the Cover

Pictured are just a few of the eight million customers 7-Eleven serves every day. With over half of the U.S. population living within two miles of a 7-Eleven, no one has to look very far to find "their" neighborhood store.

In 1927, an employee of The Southland Ice Company answered the requests of his customers by selling bread, milk and eggs from the steps of his ice dock. With that simple idea — giving customers what they want, when they want it — "Uncle" Johnny Green began a 60-year tradition of customer service and innovation that remains the driving force of Southland's 8,700 7-Eleven stores and other retail units.

Southland has never been content to do things "because that's the way things have always been done." Instead, as the founder of the convenience store industry, it has led in the development of hundreds of new products and services — around-the-clock operating hours, self-serve gasoline, dairy products and sandwiches from its own subsidiaries, automatic teller machines, and of course "Slurpee," just to name a few. These innovations and millions of satisfied customers have allowed Southland to build one of the strongest and most geographically diverse store bases in the history of retailing. The Company's superior understanding of the marketplace provides a strong foundation for another 60 years of profitable growth and service to its customers.



The Southland Corporation exists to maximize the long-term market value of shareholder equity.

Our heritage is 7-Eleven. Its profitable growth and increasing dominance in convenience retailing will remain the core of our existence.

Southland's retail focus is complemented by responsive internal sources of supply. We will continue to strengthen related manufacturing, distribution and service businesses that contribute to the corporate growth objectives and perform profitably in their respective industries.

We also recognize the profit contribution and growth potential that may be afforded by other forms of retailing compatible with our expertise and resources.

We will be successful to the degree that we fulfill the needs of our customers — what they want, when and where they want it — in a manner that provides added value, engenders loyalty and promotes a lasting relationship.

To ensure Southland's continued excellence, we must retain the flexibility to anticipate opportunities and to master all forms of competitive challenge.

Our most important resource is people. Southland excels because of the quality, motivation and loyalty of every member of the Southland family. We are committed to innovation through participative involvement, and to fostering an environment of trust, respect and shared values.

As a responsible corporate citizen, Southland will conduct its business in an ethical manner with the highest integrity, while contributing to the quality of life in the communities it serves.

The ultimate measure of Southland's success is the optimal utilization of our collective resources and the perpetuation of a culture that is distinguished for its clarity of purpose, emphasis on individual responsibility and standards of excellence.

THE SOUTHLAND CORPORATION

The Southland Corporation, which originated the convenience store concept in 1927, operates the largest convenience store chain in the world and is the twelfth largest retailer in the United States. Its activities are grouped into two business segments — convenience retailing, and food processing and manufacturing. In addition, it has a 50-percent equity interest in Citgo Petroleum Corporation, the country's largest independent refiner/marketer.

Convenience Retailing

The convenience retailing segment includes 7,672 7-Eleven stores, Southland's primary business, as well as five regional distribution centers that support the stores. Other retail operations include Chief Auto Parts, High's Dairy Stores, Quik Mart stores and Super-7 outlets.

Southland's International Division coordinates the activities of an additional 4,102 7-Eleven and other small retail units operated by area licensees and affiliates in the United States and 11 other countries. Sales from these operations are not reported in the Company's total revenues.

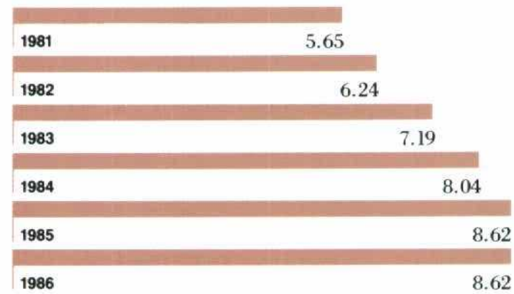
Food Processing and Manufacturing

The food processing and manufacturing segment includes Southland Dairies, one of the nation's largest dairy processors; six food centers, which produce a complete line of sandwiches and other fast foods; a snack foods division; Southland Food Labs, a manufacturer of food ingredients and specialty chemicals; Reddy Ice, the world's largest ice company; and Tidel Systems, a manufacturer of high-security cash-dispensing units and other equipment for retailers.

50-Percent Interest in Citgo Petroleum Corporation

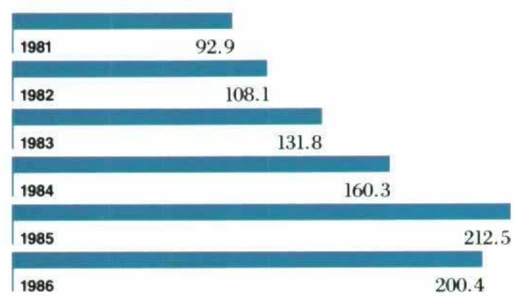
Southland's one-half ownership of Citgo Petroleum Corporation provides it with an equity interest in Citgo's results as well as a competitively priced supply of gasoline for its convenience stores. In addition, gasoline at 7-Eleven stores east of the Rocky Mountains is branded with the Citgo name, and the stores offer their customers the convenience of the "Citgo Plus" credit card.

Total Revenues *(Dollars in Billions)*



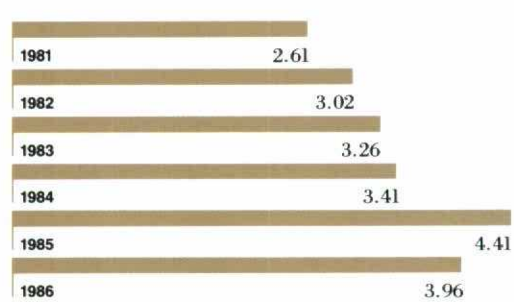
Compound Growth Rate: 8.8%

Net Earnings *(Dollars in Millions)*



Compound Growth Rate: 16.6%

Primary Earnings Per Share *(In Dollars)*



Compound Growth Rate: 8.7%

Financial Highlights

Year ended December 31	1986	1985	% Change
Financial summary *(Dollars in thousands, except per-share data)*			
Total revenues	$8,619,681	$8,622,397	—
Net earnings	200,445	212,535	(5.7)
Primary earnings per share	3.96	4.41	(10.2)
Fully diluted earnings per share	3.91	4.37	(10.5)
Cash dividends — common stock	53,877	47,405	13.7
Cash dividends per share — common stock	1.12	1.00	12.0
Capital expenditures	$ 786,898	$ 464,854	69.3
Average shares outstanding — common stock (000s)	48,094	47,400	1.5
Return on average shareholders' equity	13.02%	16.06%	
Financial condition at year-end *(Dollars in thousands, except per-share data)*			
Total assets	$3,421,088	$3,233,518	5.8
Shareholders' equity	1,667,831	1,496,823	11.4
Long-term debt	639,496	575,586	11.1
Working capital	(205,730)	(391,581)	47.5
Shareholders' equity per share of common stock	$ 31.91	$ 28.84	10.6
Debt-to-equity ratio	0.40	0.40	—
Number of shareholders of record — common stock	8,317	8,186	1.6

Our 7-Eleven stores are competing very aggressively. Marketing and operating strategies expanded or initiated in 1986 have placed us in an even better position to continue our strong, profitable growth.

The past year was very active and important for Southland.

On September 30, 1986, the Company sold 50 percent of the common stock of its Citgo Petroleum Corporation subsidiary to a subsidiary of Petroleos de Venezuela, S.A. (PDVSA), Venezuela's state-owned oil company. Results for both 1986 and 1985 have been restated to reflect the equity method of accounting, thereby excluding Citgo's sales from Southland's revenues for both years. Net earnings for 1986 included 100 percent of Citgo's loss through the first nine months, but in the fourth quarter only Southland's 50-percent interest in Citgo's earnings was included. In 1985, however, Southland's net earnings included 100 percent of Citgo's profits for all of that year.

Revenues of $8.62 billion for 1986 were equal to the record level of 1985 despite a 24-percent decline in the average retail price of gasoline, Southland's largest single product category. Net earnings of $200.4 million were 5.7 percent less than in 1985. After the first full year's dilutive effect of 2.5 million shares of preferred stock, earnings per share of $3.96 primary and $3.91 fully diluted were down 10.2 percent and 10.5 percent, respectively.

The capital gain recognized in 1986 on the sale of half of Citgo's equity was $114.7 million before profit sharing and taxes, resulting in an $88.6-million addition to net earnings, or $1.84 per primary share. The transaction, including the sale proceeds, added more than $400 million to Southland's cash flow as various intercompany accounts were cleared. Citgo also recorded a net pretax charge of $112 million for a write-down of its inventories to market value, which negatively affected Southland's 1986 earnings.

7-Eleven, our primary business, moved very aggressively during the year to meet the challenges of an increasingly competitive retailing environment. The growth opportunities for convenience retailing have attracted many new competitors over the last few years — most notably oil company gasoline/mini-convenience "g-stores," which sell a limited assortment of merchandise such as canned soft drinks, cigarettes and snack foods at prices designed to attract more gasoline customers.

Although 7-Eleven has been expanding its selection of merchandise and services for several years to appeal to new customer groups, in 1986 it dramatically accelerated investment in marketing programs, as well as store remodeling. Costs associated with these projects contributed to reduced 7-Eleven profitability in the second half of 1986 and will continue to affect the stores through at least the first half of 1987. In addition, in certain markets 7-Eleven established more competitive pricing guidelines, which reduced merchandise margins but has begun to produce higher sales and total gross profit dollars.

Merchandise sales at 7,835 7-Eleven and other Southland convenience stores increased 7.7 percent and were up 6.2 percent in stores open more than 12 months. This produced real sales growth after inflation of 3.7 percent.

Three key 7-Eleven marketing programs — fast foods, customer services and self-serve gasoline — were enhanced or expanded in 1986. Some combination of hot dogs, nachos and fresh-made deli-style sandwiches is now available at 6,500 stores, and a new hot sandwich program was introduced under the name "Get Hot" in 2,000 stores on the West Coast late in the year. Together with microwave-ready sandwiches and burritos, these items give 7-Eleven customers good value and the widest selection of high-quality quick-meal items to be found at any other convenience store or fast food outlet.

"MovieQuik," Southland's videocassette rental program, offers exciting traffic-building potential since 40 percent of all American households already own videocassette recorders, and each rental involves two trips to the store. 7-Eleven can compete effectively in this fast-growing and fragmented business by filling a very specific market niche. No other video retailer will be able to match the number of easily accessible "MovieQuik" locations open around the clock, with selections of 200 regularly rotated tapes in each store, including the most frequently requested movie titles. We are pleased that "MovieQuik" is now up and running, and the program will be expanded to most 7-Eleven stores this year.

In 1986 the Citgo gasoline brand name was proudly displayed for the first time at 2,700 7-Eleven stores east of the Rocky Mountains. Availability of the Citgo brand, together with aggressive promotion of the new "Citgo Plus" credit card, helped push total retail gasoline volume over the two-billion-gallon mark and further strengthened Southland's position as the nation's largest independent gasoline retailer. Total retail gallonage increased 4.3 percent to 2.05 billion gallons, including 10.6 percent growth at 7-Eleven. This is a healthy increase in market share since national gasoline consumption grew only about 2.6 percent. Average gross profit per gallon increased 24.6 percent, largely because of first quarter gasoline margins, the highest in the industry's history.

New store construction and acquisition accelerated, and expenditures for store remodeling doubled in 1986. Southland opened 439 7-Eleven stores for a net increase of 153 stores after closing 286 units due to relocations, changing market patterns, lease expirations and divestitures in secondary markets. At year-end, the Company acquired 346 High's Dairy Stores located primarily in Virginia and Maryland. Although these stores will continue to operate under the "High's" name, they represent a very attractive addition to Southland's store base. We also were pleased to complete the sale of the Gristede's operation, including 43 retail units, which did not offer growth opportunities compatible with our goals.

John P. Thompson Jere W. Thompson

Southland's sale of half of Citgo to PDVSA was one of those gratifying occasions when all parties emerged as winners. The sale made Citgo a much stronger refiner/marketer, partly because of the 20-year agreement for PDVSA to supply it with a minimum of 130,000 barrels per day of competitively priced crude oil and other feedstocks. This long-term supply of feedstocks enables Citgo to achieve more stable, cost-efficient operations and a more reliable product supply for its customers.

Southland will be assured of a long-term, competitively priced supply of branded gasoline for its 7-Eleven stores while retaining a one-half equity interest in Citgo. The Company will benefit not only from Citgo's reduced exposure to the margin volatility that is typical of its industry, but also from Citgo's improved competitive strength. In addition, the sale allowed Southland to recover much of its initial investment in Citgo, which can be redeployed into convenience retailing, our core business. PDVSA achieved several objectives, including access to 7-Eleven's extensive retail gasoline market through Citgo and a long-term customer whose refinery is particularly well-suited to process Venezuela's heavy sour crude oil.

Citgo's 1986 operating results were really quite good once the extremely difficult first quarter was over. Marketing efforts were intensified to increase the value of the brand for Southland and Citgo's other wholesale customers. At year-end, approximately 7,000 retail outlets were displaying the Citgo brand, including 2,700 7-Eleven stores and more than 1,000 new branded distributor outlets. Over one million "Citgo Plus" credit card accounts were added during the year, almost quadrupling Citgo's credit customer base.

Southland's International Division granted four additional 7-Eleven area licenses in 1986, the most in any single year in its history, and also reported substantially higher profits. The new licensees will operate in Panama, Norway, Guam/Micronesia and the Republic of Ireland. At year-end, 4,102 7-Eleven stores and other convenience stores were operated by licensees or affiliates in the United States and 11 other countries. We congratulate the 7-Eleven licensees in Taiwan and Australia, each of which opened its 100th store during 1986, and extend special recognition to Seven-Eleven Japan Co., Ltd., which will open its 3,000th store in early 1987, a most impressive milestone.

Our five distribution centers substantially increased their profitability and outside sales during the year. The distribution system operates coast-to-coast, serving 73 percent of Southland's 7-Eleven stores as well as many national food service and other outside accounts. Southland has the most extensive distribution system of any convenience retailer, which has been a key factor in 7-Eleven's ability to respond quickly to the rapidly changing needs and desires of its customers.

Chief Auto Parts enjoyed its most profitable year in 1986 due to increased sales and the continuation of a stringent cost control program. This industry offers strong potential growth, especially with the successful application of Southland's convenience retailing concepts.

The Dairies Group continued its four-year record of very solid sales and profit growth by aggressively seeking new business opportunities and carefully controlling production and distribution expenses, a strategy that has enabled it to consistently outperform its industry. While providing important support for 7-Eleven, the Group also continues to expand its highly profitable outside business. We're very pleased that the Dairies Group's achievements resulted in its being named 1986 Dairy Processor of the Year by Dairy Foods magazine.

Southland's 1986 capital expenditures totaled $786.9 million, including $561.7 million for convenience retailing. The majority of that amount was invested in 7-Eleven for new stores, remodeling and support of our marketing programs. We remain very confident of the many growth opportunities available in our core business and will continue to pursue those that best complement our strategic direction.

In early 1987, Cityplace Center East Corporation, a subsidiary of Southland, issued $290 million of public debt to fund a portion of the Company's new 42-story Dallas headquarters and allocated infrastructure costs associated with the entire Cityplace project. The debt is nonrecourse to Southland and backed by a bank letter of credit. The headquarters will allow the Company to consolidate approximately 1,700 employees now located in 16 buildings. The planned companion tower will not be built until significant tenant preleasing is obtained, and the balance of the Cityplace acreage will be developed over the next 20 years as market conditions warrant.

Southland and 7-Eleven have always practiced good corporate citizenship, not just because we feel it is the right thing to do, but also because it makes good business sense to support the needs of the communities in which we operate. Our employees, franchisees, customers and suppliers raised $4.7 million for the Muscular Dystrophy Association this year, bringing our total since 1976 to almost $50 million, more than any other corporate sponsor of the Jerry Lewis Labor Day Telethon. Employees and franchisees also raised $1.8 million for the March of Dimes WalkAmerica.

Just as 7-Eleven continually modifies its merchandise mix to serve its customers better, we also periodically review the effectiveness of our management structure in supporting our business units. As the result of a particularly intensive review completed in 1986, we reorganized and aligned certain corporate staff functions with the business units that they primarily serve, eliminating duplication, trimming nonessential internal functions and increasing our overall responsiveness and efficiency. At the same time, we consolidated five regional stores operations into four. We are pursuing additional ways to make your Company an even more cost-efficient provider of high-quality products and services in order to maximize shareholder value.

In January the Board of Directors continued the current annual dividend rate of $1.12 per share on Southland's common stock. This maintains the dividend payout within the range of 25-30 percent of prior-year net earnings, the Board's longstanding guideline. The first quarterly dividend of $.28, to be paid on March 20, 1987, to shareholders of record on February 27, will begin the Company's 31st year of uninterrupted dividend payments.

1986 was indeed an active and important year for Southland. The sale of half of Citgo achieved some important objectives, including strengthening our balance sheet. Recent marketing and operating strategies have placed us in an even better position to continue our strong, profitable growth. With almost 8,000 highly visible locations and a 60-year tradition of customer service, 7-Eleven has one of the strongest retail bases in North America, ably supported by food processing, distribution and manufacturing businesses that provide the Company with profitable outside sales and an excellent return on investment.

Everyone at Southland is committed to making your Company an even tougher competitor in order to take full advantage of our many exciting opportunities. We sincerely appreciate the efforts of our employees, franchisees and suppliers, as well as the continuing support and loyalty of you, our shareholders.

John P. Thompson

John P. Thompson
Chairman of the Board

Jere W. Thompson

Jere W. Thompson
President and Chief Executive Officer

March 16, 1987

The history of 7-Eleven is remarkable, not only for its dramatic and profitable growth from the steps of a humble ice dock, but also for the creativity and even humor that it has brought to the marketplace.

New ideas and the ability to stay on the leading edge of trends have made 7-Eleven an integral part of the American lifestyle. But 7-Eleven hasn't been content just to innovate. Some of its brightest moments came when it also entertained or set out to startle its customers with bold new imagery — from the large colorful totem poles in front of the original "Tote'm" stores, the world's first retail pole signs . . . to the award-winning 1962 commercial featuring two talking watermelon seeds held captive deep inside an ice-cold 7-Eleven melon . . . to 7-Eleven's gravelly voiced radio announcer Y. Y. Wickie, who explains how he invented this "'cold stuff' called ice."

How do you keep almost eight million customers a day happy and coming back for more? You never lose sight of what makes 7-Eleven successful — providing the best service to its customers in the most efficient way possible. This emphasis on service produces a profitable, growing company, which in turn creates added value for its shareholders.

Southland remains committed not only to anticipating and meeting the needs and expectations of its customers, but also to exceeding them whenever possible — just as it has been doing for 60 years.

1928 *Gasoline was first sold at a convenience store only 25 years after the birth of the Model A. Southland built and leased gasoline kiosks to oil companies at 10 of its "Tote'm" stores.*

1936 *Opening its own dairy was a natural step for Southland when it became the largest seller of milk products in north Texas. Oak Farms was the first of the Company's 10 regional dairies, now one of the largest dairy operations in America, which efficiently serve 73 percent of all 7-Eleven stores and thousands of other customers.*

1946 *"7-Eleven" first appeared as the name for all retail units owned by Southland, and the modern convenience store era began. The name, emblazoned on a lucky four-leaf clover, heralded the stores' 7 a.m. to 11 p.m. operating hours, a completely new idea in customer service.*

1948 *When the forerunner of today's 7-Eleven pole sign first appeared, most sales were through curb service, a legacy from Southland's ice docks. Open store-front designs were another customer convenience.*

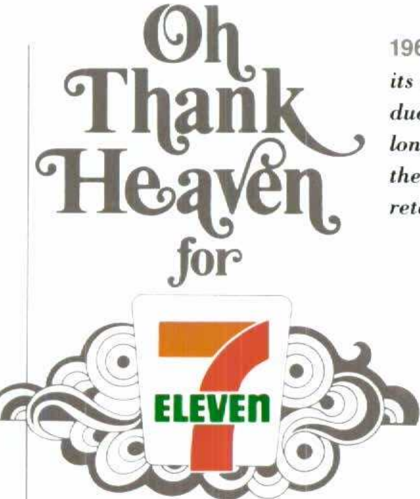
1954 *Geographic expansion began with the first 7-Eleven in Florida. A move to Virginia in '57 proved 7-Eleven worked in all climates, and a major California acquisition in '64 introduced Southland to franchising.*

1963 *In tune with the changing lifestyles of its customers, 7-Eleven began operating stores "around the clock" — the first retail chain to do so.*

1949 *7-Eleven's animated "Owl and Rooster" commercial was the first television advertising by a convenience chain. Customers remembered the chant-type jingle, "Seven days a week, we open up at seven. And seven days a week, we're open 'til 11. We've got soup to nuts and that's why we sing, 7-Eleven's got everything."*

1954 *Known as "the little store that had everything," 7-Eleven quickly learned to meet and even anticipate the needs and desires of its customers. Do-it-yourself television tube testers were an instant success, as were key-making machines and later, money order sales.*

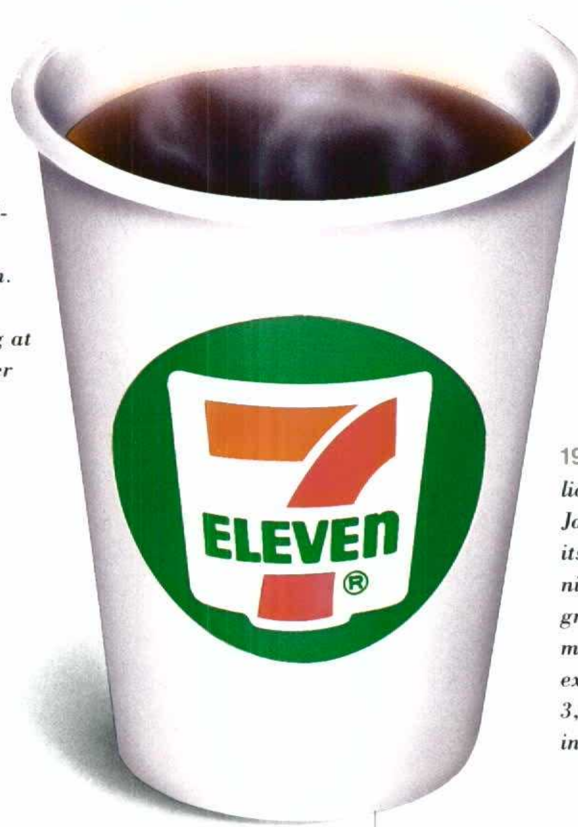
1965 *7-Eleven introduced a new drink, soon to be known as "Slurpee," mimicking the sound made when drunk through a straw. Colorful flavor names like "Fulla Bulla" and "Leprechauns' Brew" and theme promotions have kept children of all ages slurpin' for more than 20 years.*



1969 *Echoing the sentiments of its customers, Southland introduced one of the best-loved and longest-lasting advertising themes in the history of retailing.*

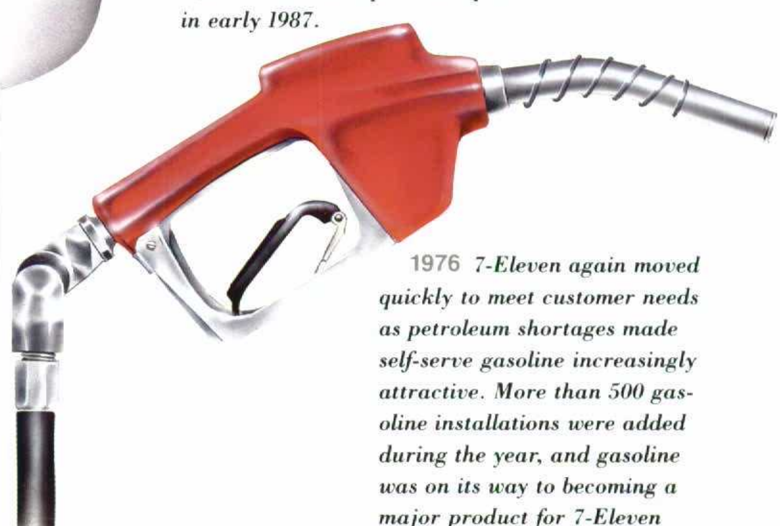
1971 *The first of five regional distribution centers opened in Florida. Its new "single unit" ordering concept enabled 7-Eleven to offer a wider merchandise variety in a small selling space. Almost three-fourths of the 7-Eleven stores and many other customers now benefit from the coast-to-coast distribution system, the most extensive in the convenience retailing industry.*

1969 *An early morning tradition began with the debut of "hot-to-go coffee" at 7-Eleven. Customers know they can always find a fresh pot brewing at 7-Eleven, which now sells over one million cups a day.*



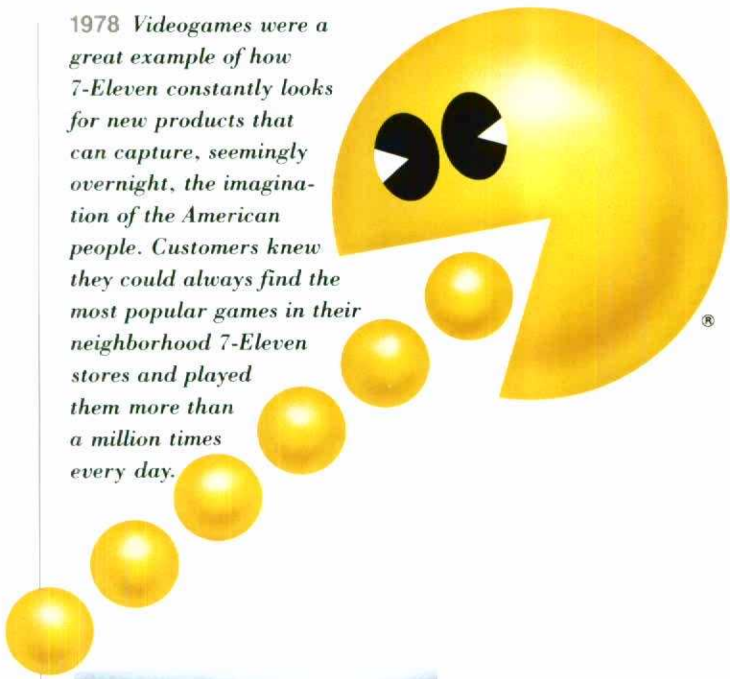
1974 *The area licensee for Japan opened its first 7-Eleven store, beginning a phenomenal decade of growth and representing a major step in overseas expansion for Southland. The 3,000th store in Japan will open in early 1987.*

1969 *A new Smileys sandwich plant in Fort Lauderdale, Florida, began Southland's successful venture into fast foods. As early as 1959, 7-Eleven was experimenting with microwave-cooked fast food products.*



1976 *7-Eleven again moved quickly to meet customer needs as petroleum shortages made self-serve gasoline increasingly attractive. More than 500 gasoline installations were added during the year, and gasoline was on its way to becoming a major product for 7-Eleven customers.*

1978 *Videogames were a great example of how 7-Eleven constantly looks for new products that can capture, seemingly overnight, the imagination of the American people. Customers knew they could always find the most popular games in their neighborhood 7-Eleven stores and played them more than a million times every day.*

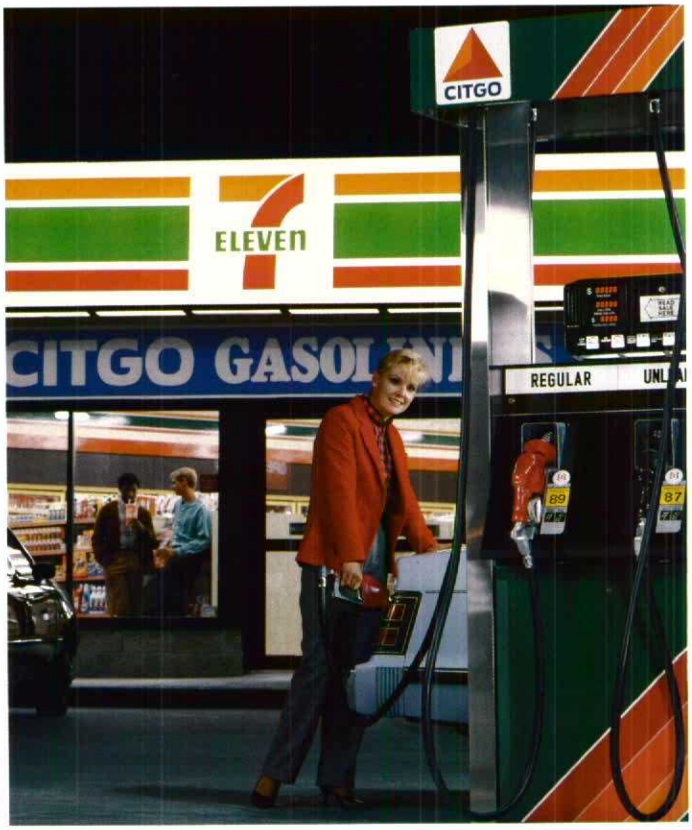


1978 *Southland applied the convenience retailing concept to a new field with the acquisition of 119 Chief Auto Parts stores in Southern California. About half of all car owners do some of their own repairs, and at Chief they find everything they need.*

1982 *7-Eleven offered its customers the "freedom of choice" between Coca-Cola and Pepsi-Cola in the same soda fountain — a first in the soft drink industry. Today, 7-Eleven is one of the top sellers of fountain soft drinks, due to the customer appeal of value pricing and a choice of at least six beverages.*

1983 *Southland's acquisition of Citgo Petroleum Corporation provided 7-Eleven with an assured supply and extensive distribution system for gasoline, its largest single product category.*

1986 *The modern 7-Eleven represents many evolutions since the days milk, bread and eggs were sold from the side of an ice dock. Automatic teller machines, videocassette rentals, fast foods, self-serve soda fountains and large gasoline canopies are just a few of the features of the new 7-Eleven, still "the little store that has everything."*



As one of the best-known and most innovative retailers in America, 7-Eleven relies on its store managers, franchisees and employees to uphold Southland's 60-year tradition of customer service.

The convenience retailing segment, comprised mainly of 7,672 7-Eleven stores, accounted for 93.3 percent of Southland's sales in 1986. The segment also includes 465 Chief Auto Parts stores, 163 Quik Mart and Super-7 high-volume gasoline locations, and five regional distribution centers that primarily serve 7-Eleven. As of December 30, 1986, the segment added 346 High's Dairy Stores acquired when Southland bought the assets of Capitol Milk Producers Cooperative, Inc., although the operations were not included in the segment's results for the year.

Merchandise sales for the segment were up a solid 6.9 percent over 1985. Total sales of $8.0 billion were down 0.7 percent, however, because of a rapid industrywide decline in retail gasoline prices early in the year that offset a healthy increase in number of gallons sold. Segment profits of $264 million were 1.5 percent higher than the prior year, despite economic and operating factors that lowered 7-Eleven profits. In addition, operating losses sustained by the Gristede's retail units in New York City, which were sold during the year, had a negative impact on segment profits.

Southland expanded its competitive pricing strategy and significantly accelerated the development and introduction of new marketing programs in 1986. These actions further pressured 7-Eleven profitability, which had been hampered by the continuing economic slowdown in many southern and midwestern markets affected by depressed energy, construction and agricultural industries.

7-Eleven lowered merchandise prices in selected markets, chiefly in the southeast, to strengthen its competitive position. The resulting higher sales and increased market share began to improve total gross profits, although gross margins were depressed by the aggressive promotions in those areas. The stores also incurred significant start-up expenses to introduce several major products and services such as "MovieQuik" videocassette rentals. These marketing programs, together with related store reconfigurations, are expected to create an even greater distinction between 7-Eleven and gasoline/mini-convenience "g-stores."

Merchandise sales at the 7,835 convenience stores increased 7.7 percent, and were up 6.2 percent in stores open more than 12 months. Real growth in merchandise sales after inflation was 3.7 percent, meeting the Company's three-to-five percent goal.

Southland strengthened its position as the nation's largest independent gasoline retailer in 1986. Total retail gallonage grew 4.3 percent to 2.05 billion gallons, which included a 7-Eleven gallonage increase of 10.6 percent, continuing the past decade's record of steady growth despite essentially flat U.S. consumption.

The addition of the Citgo brand name to 7-Eleven gasoline at 2,700 stores east of the Rocky Mountains and the introduction of the new "Citgo Plus" credit card contributed to the increased volume. Both actions were implemented in early 1986 to differentiate 7-Eleven's gasoline program from other independent retailers.

Over one million new "Citgo Plus" accounts were opened during the year, almost quadrupling the number of customers who can use their cards for both gasoline and merchandise purchases at 7-Eleven. The convenience of the card and aggressive promotions, together with substantially lower average prices, increased the percentage of fill-ups and produced a 35.6-percent average gain in per-store gallonage for higher-margin super unleaded gasoline.

Gasoline was available at 3,594 7-Eleven stores and other retail units, or about 44 percent of all locations, at year-end. The average gross profit per gallon increased 24.6 percent, in large part due to unusually high margins during the first quarter. Gasoline gross profits increased 29.9 percent to $193.2 million for the year. Self-serve gasoline is an important part of Southland's marketing program because it is a significant sales and profit contributor, as well as an in-store traffic builder. One-third of all gasoline customers also buy merchandise.

Segment Operating Results *(Millions)*

	1982	1983	1984	1985	1986
Outside Sales	$5,819.7	$6,775.5	$7,552.6	$8,054.9	$7,999.3
Operating Profit	222.0	237.4	268.2	259.9	264.0

The pace of store expansion increased significantly during the year as Southland opened or acquired 785 convenience stores, including 439 7-Eleven stores and 346 High's Dairy Stores. A net increase of 153 7-Eleven stores resulted after 65 stores were relocated to better sites, another 173 were closed due to changing market patterns and lease expirations, and 48 stores in secondary markets were divested. The Company also closed 75 Quik Mart and Super-7 stores, including 14 that were transferred to Citgo and 26 that were scheduled for conversion to 7-Eleven locations.

7-Eleven, one of the best-known names in America, also has one of the strongest retail bases, with over half of the U.S. population living within two miles of a store. 7-Eleven serves customers in 49 states, including Alaska and Hawaii, and the District of Columbia and five provinces of Canada. Franchisees operate 38 percent of the 7,672 Company units, while 10 domestic area licensees operate another 494 stores in portions of certain states. 7-Eleven's unique market position creates exceptional opportunities for innovative new products and services. Extensive promotion of expanding fast food programs, customer services and self-serve gasoline is attracting new customers while increasing shopping frequency.

The 7-Eleven fast food program was broadened both geographically and in product choice during 1986. Fresh-made, deli-style sandwiches are now prepared on-premises at 3,600 stores, and hot dogs and nachos are available at 6,500 locations. To supplement the fresh fast foods menu, hot sandwiches were introduced in 2,000 West Coast stores late in the year with the advertising theme "Get Hot." These products, prepared by the Southland Food Centers, include hamburgers and three other hot sandwiches, six pastries and three breakfast sandwiches. Self-serve fresh condiment bars increase the appeal of the new sandwiches, which will be expanded to additional stores in 1987.

Fresh fast foods and hot sandwiches, along with such popular and well-established products as "Slurpee," 7-Eleven coffee and "Big Gulp" fountain soft drinks, provide 7-Eleven customers with a unique blend of choice, quality and convenience. 7-Eleven continued to develop this strategy in 1986 by initiating in-store tests of fast food concepts including branded programs such as "Hardee's" and "Church's Fried Chicken," as well as its own programs.

7-Eleven is also aggressively expanding its specialized customer services, including automatic teller machines (ATMs), money order sales and videocassette rentals, which are not generally available in smaller competing retail units. These services have already demonstrated their potential for broadening 7-Eleven's customer base and increasing merchandise and gasoline sales.

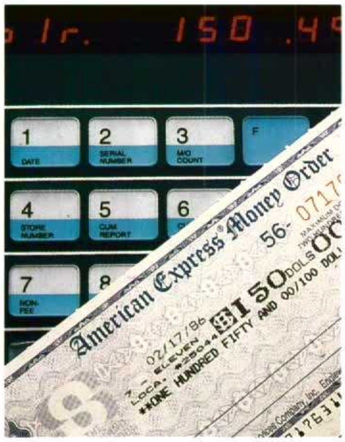
The ATM program provides convenient 24-hour cash dispensers utilizing a wide variety of bank cards at 1,500 stores. More than one-third of 7-Eleven ATM customers visit the stores primarily because of the machines, and many purchase gasoline or merchandise. ATMs are a natural extension of special 7-Eleven customer services such as the sale of money orders, which began 30 years ago. Today, 7-Eleven is second only to the United States Postal Service in money order sales, and is greatly increasing the security and sales potential of this service with the installation of new timesaving electronic money order machines, which are now in 5,500 stores.

Convenience Store Sales by Category

Gasoline	22.1%
Tobacco Products	15.8
Beer/Wine	11.7
Soft Drinks	10.9
Groceries	8.6
Food Service	8.1
Non-Foods	6.4
Dairy Products	5.2
Candy	4.0
Baked Goods	3.5
Health/Beauty Aids	2.6
Customer Services	1.1
Total	100.0%

The Company does not record sales by product lines, but estimates the percentage of 7-Eleven sales by principal product category based upon total store purchases.

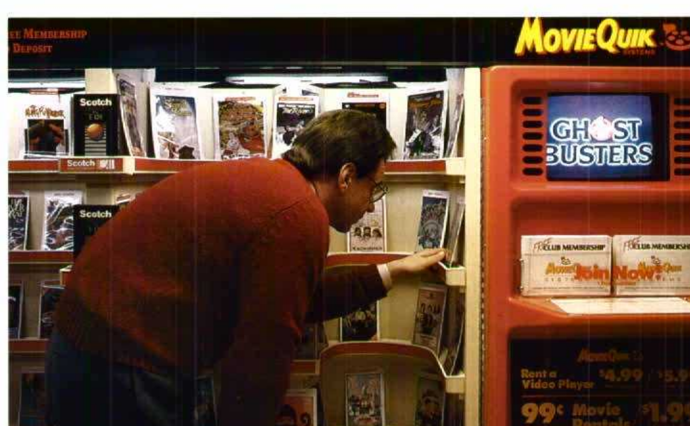
New electronic money order machines substantially reduce average transaction time, greatly increasing the sales potential of this traffic-building customer service.



Already established as America's largest independent gasoline retailer, Southland continued to increase its volume in 1986. Branding of gasoline with the Citgo name at 2,700 stores helped increase 7-Eleven's gallonage 10.6 percent.

Submarines, ham-and-cheese and turkey are just a few of the deli-style sandwiches now made fresh daily at 3,600 stores. Along with hot dogs, chili dogs and nachos available at 6,500 stores, these items offer 7-Eleven customers one of the widest possible choices for a fast, high-quality meal.

7-Eleven's "MovieQuik" videocassette rental program offers easily accessible locations that never close and regularly rotated 200-tape selections including the most popular titles. "MovieQuik" has important traffic-building potential since each rental involves two trips to the store.



"MovieQuik," Southland's videocassette rental program, fills a market niche not covered by large video outlets or small individually owned rental stores. Easily accessible locations that never close, as well as competitive prices and a regularly rotated 200-tape selection including the most frequently requested movie titles, will make 7-Eleven a strong force in this fast-growing business.

"MovieQuik's" customer base and potential for related sales are excellent. About 40 percent of all American households currently own videocassette recorders, and 80 percent are projected to have them by 1990. In addition, each rental involves *two* trips to the store, and the peak rental period occurs during the winter, historically 7-Eleven's slowest season. "MovieQuik" is expected to be available in most 7-Eleven stores in 1987.

Southland's International Division achieved excellent profit gains in 1986 while also granting new area licenses for 7-Eleven stores in Panama, Norway, Guam/Micronesia and the Republic of Ireland.

At year-end, Southland International was coordinating the activities of 4,102 7-Eleven stores operated primarily by licensees in the United States and 11 other countries. Licensees in the Far East and South Pacific once again led store growth, with a net addition of 476 units. Seven-Eleven Japan Co., Ltd., opened 332 of these stores, for a year-end total of 2,924. The other licensed countries and the number of stores open at the end of 1986 were: Hong Kong, 183; Taiwan, 122; Singapore, 44; Malaysia, 31; Australia, 119; the Philippines, 3; England, 52; and Norway, 1. Ten American licensees were operating 494 7-Eleven stores in designated areas of 20 states.

The Company's Swedish subsidiary operated 68 7-Eleven stores at year-end. In addition, Southland owns an equity interest in a company that operates 61 convenience stores in Mexico.

Sales from stores included in the International Division are not reported as revenues of Southland. Royalties from licensees, however, are included in the convenience retailing segment's operating profit.

Southland's five distribution centers serve 73 percent of the 7-Eleven stores, as well as other retail and food service accounts in 40 states and the District of Columbia. Profits increased substantially during the year due to strong outside sales growth and effective expense controls. Total 1986 sales of $1.43 billion, which were up 16.1 percent, included outside sales of $306.2 million.

The distribution centers are strategically located in Florida, Texas, Virginia, Illinois and California to provide coast-to-coast service to 7-Eleven and outside customers. Computerized ordering and route scheduling and the ability to supply products in small "broken case" quantities enable distribution center customers to manage their inventories more efficiently, maintain fresher merchandise, and generate higher sales and profits in limited selling space.

Southland's Chief Auto Parts Division is the nation's largest convenience retailer of automobile replacement parts and accessories operating under one name, with 465 stores located mainly in California and Texas. Chief substantially improved its sales and operating profits during 1986, in part due to its more established store base and a highly effective expense control program. In early 1987, Chief relocated its growing Texas distribution operation to a larger, fully automated warehouse.

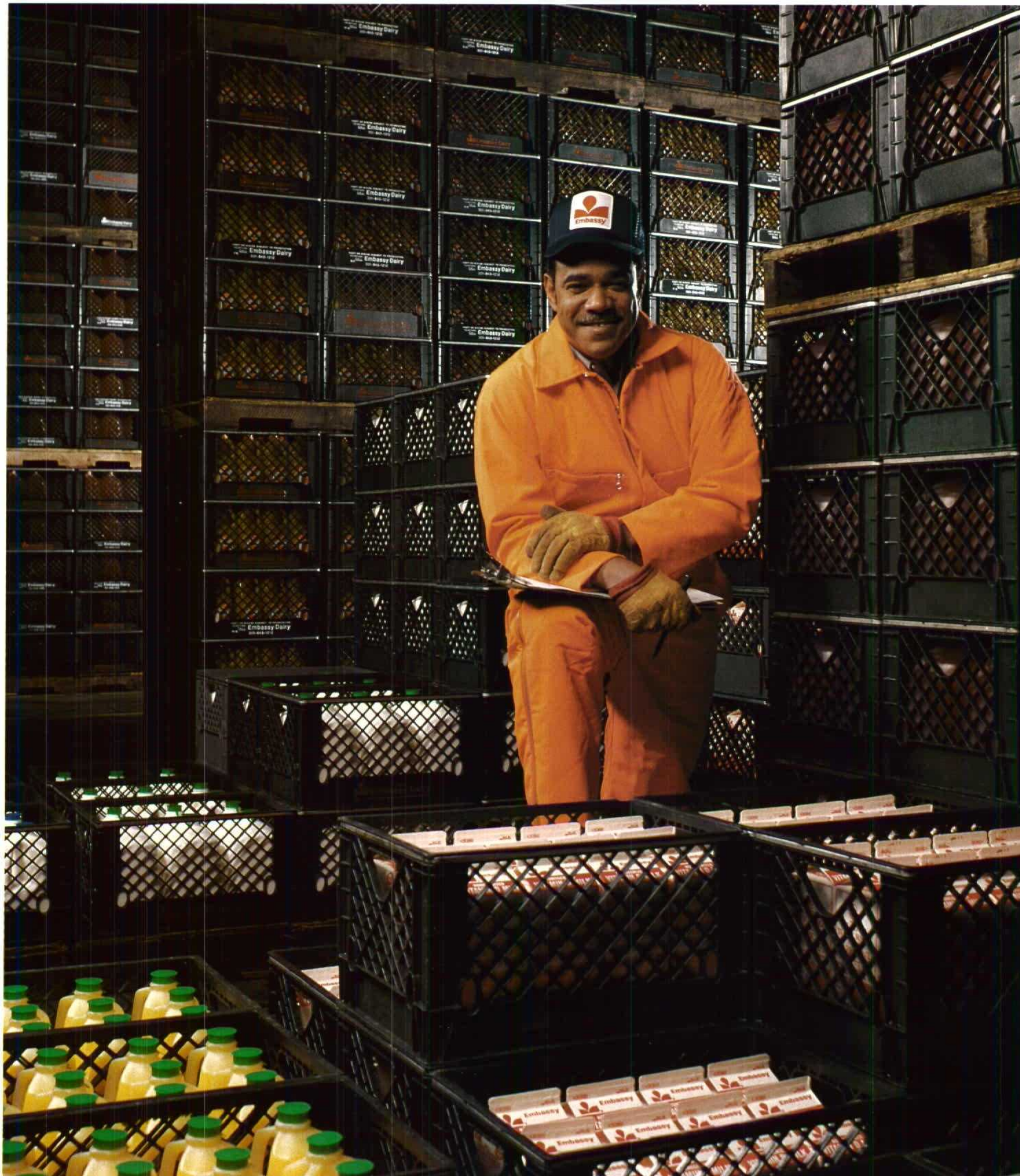
Chief also began installing computerized cash register and parts catalog systems in 1986. While enhancing service to its customers, these systems increase the productivity of store personnel and improve inventory management. For example, the computerized catalog automatically lists the correct parts for the specific make and model of a customer's car, suggests related sales, and notes where an item can be ordered if not currently in stock. Both systems are expected to be operational throughout the chain by late 1987.

Chief Auto Parts, the largest retailer of automobile replacement parts operating under one name, enlarged its Texas distribution operation during the year for better support of its growing sales.

Customers in 11 foreign countries shop at neighborhood 7-Eleven stores. The Norwegian area licensee opened its first store in Oslo in 1986, one of 3,608 international stores open at year-end.

Five highly automated centers comprise the most extensive distribution system in convenience retailing, enabling 7-Eleven to respond quickly to customer needs.

The dairies, food centers and other support operations enhance 7-Eleven customer service by regularly supplying a wide variety of high-quality products to the stores, while also maintaining very profitable outside business.



The Dairies Group, six Southland Food Centers and five additional businesses comprise the food processing and manufacturing segment. The operations of this segment make and distribute products to 7-Eleven stores and other Southland businesses and have also developed substantial profitable outside sales. Excellent results from the Dairies Group and Tidel Systems increased segment operating profits an outstanding 18.2 percent over a record year in 1985. Total sales increased 8.0 percent to $868.5 million. This total included outside sales of $572 million, which accounted for 6.7 percent of Southland's total sales.

The Dairies Group includes 10 regional dairies operating under their own well-known brand names and is one of the three largest dairy processors and distributors in the nation. Its products are distributed in 46 states, the District of Columbia, Canada, Guam and the Caribbean from 28 plants and 62 distribution points. Dairies Group customers include 5,600 7-Eleven stores and thousands of other retail, institutional and food service accounts.

Sales in 1986 increased 5.1 percent, with outside accounts representing 60.2 percent of the total. Operating profits increased substantially for the fourth consecutive year, despite the added costs of assimilating three new plants. As of December 30, 1986, the Dairies Group also added two High's dairy plants acquired when Southland bought the assets of Capitol Milk Producers Cooperative, Inc., although they were not included in the year's results.

Southland's Dairies Group continues to gain market share and increase profits in what has been described as a "mature" industry by offering a full line of products and services at competitive prices, by developing innovative new products to meet the changing needs and desires of its customers, and by strictly controlling costs.

The Dairies Group has consistently outperformed its industry for several years because of a successful strategy to fill very specific market niches. Most of the Group's regional dairy operations emphasize direct sales of milk and other products to convenience stores, grocery chains and food service customers.

In addition, three of the divisions serve as a "dairy's dairy," by making cultured, ultrapasteurized and frozen items for other companies. One-fourth of the Dairies Group's sales go to approximately 260 outside dairy customers, making the Group one of the largest, if not the largest, supplier to other dairies in the country.

Finally, the Dairies Group produces and distributes national brands of milk and juice products, ice cream and frozen novelties, such as Dole "Fruit 'N Juice" bars, under licensing agreements with several of the country's leading food marketers. Because of the success of this multifaceted strategy, as well as its achievements in production and distribution, the Dairies Group was named 1986 Dairy Processor of the Year by Dairy Foods magazine.

The Dairies Group completed a major upgrade of its premium "Barricini" ice cream line during 1986, with improved taste, additional flavors and new packaging, all supported by an aggressive advertising campaign. A new product, the "Barricini Brownie Ice Cream Sandwich," was introduced in early 1987. In addition, individually wrapped snack-size cheeses were introduced to respond to growing customer preference for light, healthy snacks.

The Dairies Group also extended its licensed products line with production of Johnston's "Hot Scoop," the industry's first microwaveable hot fudge sundae, and frozen novelties based on the "Peanuts" cartoon characters. Increased sales of established licensed products, such as A&W "Root Beer Float-on-a-Stick," Dole "Fruit 'N Juice" and "Fruit 'N Cream" bars and "Fruit Sorbet," created a need for two additional frozen novelty plants that were acquired in 1986.

Segment Operating Results *(Millions)*

	1982	1983	1984	1985	1986
Outside Sales	$397.0	$395.8	$443.6	$517.5	$572.0
Intersegment Sales	234.9	263.8	282.2	286.6	296.5
Total Sales	631.9	659.6	725.8	804.1	868.5
Operating Profit	17.8	24.7	29.2	32.3	38.2

All of these licensed products are made on a national exclusive basis except for "Hot Scoop," which is supplied by Southland for markets east of the Rocky Mountains.

The Group acquired another juice plant to accommodate increased demand for the dairies' popular "Mission San Juan" all-natural premium fruit juices. The new plant also packages pure fruit juices in aluminum cans, a first for Southland.

The Company's six food centers provide their customers across the country with a full line of sandwiches, burritos, French bread pizzas, snack cakes, syrups for "Slurpee" and other beverages, and cheese, chili and pizza sauces. Although they primarily support the 7-Eleven fast food program, over the last three years the food centers have substantially increased sales to vending, institutional and other convenience store accounts. In 1986 outside sales accounted for 47.1 percent of the total.

The Champaign, Illinois, food center completed a major installation of equipment for processing cheese and pizza sauces during the year. The increased capacity made it possible for the food centers to market their cheese sauce nationally, a major factor in the year's growth in sales and profits. One of the most promising new products in 1986 was 7-Eleven's "Get Hot" line of sandwiches, which the food centers prepare and assemble for 2,000 stores. The St. Louis plant also introduced a brownie, which is delivered frozen in sheet-form. It is thawed and frosted with rich chocolate icing at the store for maximum taste, freshness and visual appeal. The brownie, currently available at 1,450 7-Eleven stores, is one of the more popular baked items.

The Pate Foods and El-Ge Potato Chip operations, Southland's snack foods division, both extended their product lines during the year. Pate, which produces and distributes corn chips, popcorn and other corn-based products, introduced "MovieQuik" popcorn, which should have particular appeal for 7-Eleven's videocassette rental customers. El-Ge introduced a premium line of hand-cooked potato chips and began to distribute an assortment of dips and nuts under its own name, which is well-known in the Northeast.

The Southland Food Labs manufacture a broad line of food ingredients and specialty chemicals for other Southland operations and many outside customers. The division recently developed and began supplying 7-Eleven with a group of sanitizers and cleansers for equipment used in the stores' rapidly expanding fast food program, and it continues to produce "Slurpee" flavor concentrates for 7-Eleven's popular semi-frozen carbonated soft drink. It also aseptically processes fruits and flavors, using a technologically advanced cooking and packaging method for enhanced taste and color, as well as longer shelf life. These fruits are used in numerous products such as fresh and frozen yogurt.

Reddy Ice, Southland's original business and the largest manufacturer of fragmentary ice in the world, operates nine plants, in Texas, Florida, Oklahoma and Nevada. In 1986 it opened the country's most modern ice plant, located in Davie, Florida. The new facility has 30 percent more production capacity than the plant it replaced and will serve the increasing demand in southern Florida.

Tidel Systems, which manufactures cash dispensing and underground gasoline tank monitoring systems, posted its sixth consecutive year of record sales and profits in 1986, largely due to increased sales of its "Gas Tank Monitor." This device, using sonar and microprocessor technology, provides gasoline retailers with centralized inventory control for multiple store locations and detects leaks in underground storage tanks. Tidel has entered into an agreement with a major gasoline equipment manufacturer and supplier for worldwide sales of the monitor.

In addition, Tidel developed a computer interface system providing instant payments for winners of up to a specified amount in California's state lottery. The machine, which is based on the same technology as Tidel's "Timed Access Cash Controller," allows winning numbers to be verified instantly and then paid automatically. This service for lottery ticket customers increases store traffic and provides for more secure cash management.

Southland's food centers play a key role in supplying 7-Eleven's new line of sandwiches, which was introduced under the name "Get Hot" in 2,000 stores during the year. The centers also supply chili, cheese and pizza sauces, baked goods, burritos, French bread pizzas, "Slurpee" syrups and other items to the stores.

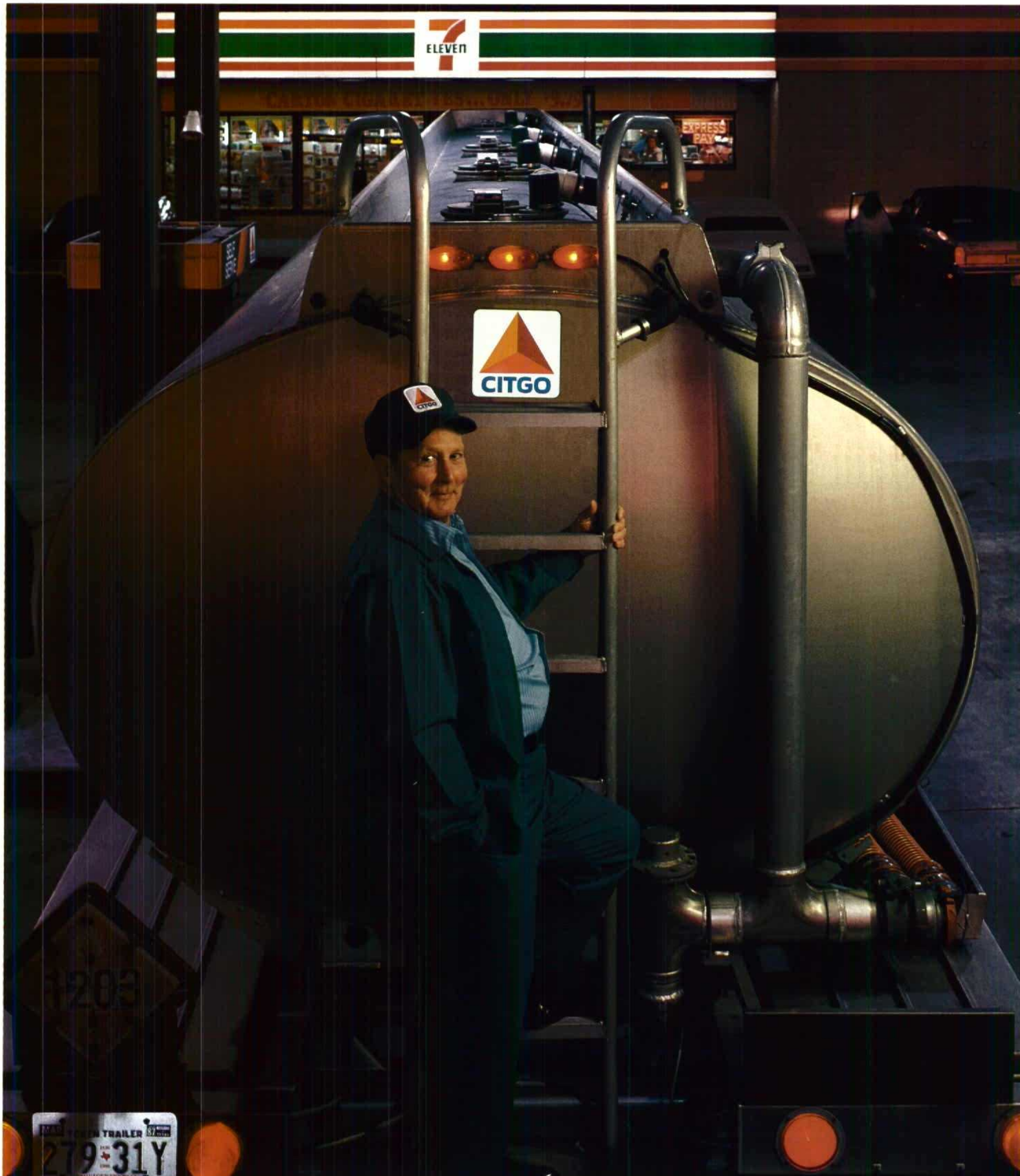
Reddy Ice is Southland's original business and the largest fragmentary ice manufacturer in the world, with nine plants operating in four Sunbelt states.

The Dairies Group began production of Johnston's "Hot Scoop," the industry's first microwaveable hot fudge sundae, in 1986. It joins a long list of popular products made by Southland under license for other companies, such as A&W "Root Beer Float-on-a-Stick" and Dole "Fruit 'N Juice" and "Fruit 'N Cream" bars.

Pate Foods' new "Movie-Quik" popcorn is offered in a variety of packages, including a single-serving microwave-ready box with a special reflective strip that helps eliminate unpopped kernels.

50-PERCENT INTEREST IN CITGO PETROLEUM CORPORATION

Southland's one-half ownership of Citgo gives 7-Eleven customers the benefits of an efficient, well-known gasoline marketing and transportation operation, including credit card convenience and competitive product pricing.



On September 30, 1986, Southland sold for $290 million cash one-half of its interest in Citgo Petroleum Corporation, the nation's largest independent refiner/marketer, to a subsidiary of Petroleos de Venezuela, S.A. (PDVSA), Venezuela's state-owned oil company. This unique transaction enabled Southland to keep the strategic advantages that resulted from its acquisition of Citgo while reducing its exposure to the earnings volatility that is characteristic of the refining and marketing industry. In addition, Southland recovered a significant portion of its initial investment in Citgo while retaining a reliable long-term, competitively priced supply of gasoline for its 7-Eleven stores. The agreement provided Venezuela with access to Southland's extensive retail gasoline network through Citgo, as well as a refinery that is particularly well-suited to process its heavy crude oil.

This combination also makes Citgo a much stronger competitor for several reasons. First, PDVSA will provide Citgo with a long-term supply of at least 130,000 barrels per day of crude oil and other feedstocks at market-related prices from the fourth largest oil reserves in the world. This will enable Citgo to achieve more stable, cost-efficient operations and a more reliable product supply for its customers. Second, as the largest independent gasoline retailer in the U.S., 7-Eleven complements Citgo's existing branded distributor network, thereby greatly enhancing Citgo's marketing presence. Third, Citgo's modern, efficient light fuels and lubricants refineries, coupled with its extensive pipeline distribution system, enable it to capitalize on the strengths of both Southland and PDVSA. Finally, Citgo is financially well-positioned for future growth due to its own $500-million revolving credit facility, as well as subordinated debt facilities from Southland and PDVSA totaling $200 million at year-end.

As a result of the sale, Southland now reports its interest in Citgo's results using the equity method of accounting as "Equity in earnings (loss) of Citgo" and has restated its financial statements accordingly. Southland's $52-million equity interest in Citgo's loss for 1986 included 100 percent of Citgo's results through the first nine months of the year, before the sale, and 50 percent of its net profit in the fourth quarter.

Citgo's 1986 loss included a net pretax, non-cash inventory write-down of $112 million, which overshadowed an excellent overall operating performance. Write-downs totaling $156 million during the first nine months were required by drastic industrywide deterioration in wholesale refined product prices, and were partially offset by a write-up of $44 million in the fourth quarter as market prices improved. The write-downs were proportionately more severe for Citgo than for some refiner/marketers, because Citgo's cost basis in its inventories was established at the time it was purchased by Southland in 1983, when refined product prices were considerably higher.

During the first quarter of 1986, wholesale prices for refined products plunged after the sharpest drop in crude oil prices in history. However, each of Citgo's business units — light fuels and industrial products, as well as lubricants and specialty products — capitalized on improving business conditions after the first quarter to achieve outstanding full-year operating results.

Citgo also dramatically increased its use of the less expensive heavy sour crude oil to a record 51 percent of the refinery's total crude oil feedstock, up from 28 percent in 1985. This very beneficial change in feedstock mix improved light fuels margins and was made possible in part by Citgo's crude oil supply agreement with PDVSA. Under this agreement, Citgo significantly reduced its exposure to the magnitude of operating loss that can accompany downturns such as that experienced in the first quarter. After this arrangement was implemented on an interim basis in early 1986, Citgo's refining margins became much more predictable, moving within a considerably narrower range. While Citgo's agreement with PDVSA neither affects inventory valuations nor totally insulates its operating earnings from the vagaries of the market, it should continue to make Citgo's earnings much less volatile than in the past.

Citgo's light fuels operation includes its Lake Charles, Louisiana, refinery — the eighth largest in the United States — as well as its extensive branded wholesale marketing and distribution network. The refinery is almost tailor-made for Venezuela's heavy sour crude oil since it has a very high "conversion" capability, meaning it can convert large quantities of low-value residual fuel oil into high-value transportation fuels such as gasoline and aviation fuel. In addition, the refinery is equipped for efficient production of high-octane unleaded gasoline, which is rapidly increasing in importance as leaded regular gasoline is phased out of the marketplace and more automobile owners switch to premium unleaded fuel. Almost 95 percent of the refinery's 1986 gasoline output was unleaded.

Citgo sold approximately seven billion gallons of gasoline, distillate and aviation turbine fuel in 1986. Almost two billion gallons of gasoline were sold to Southland, representing nearly 90 percent of its annual requirement. Of the remaining 3.2 billion gallons of gasoline, the majority was sold to over 300 independent wholesale distributors who serve 4,175 Citgo-branded retail units. Citgo also supplies two billion gallons of heating oil, diesel and other refined products across the country, including about six percent of the nation's aviation turbine fuel to 21 major airports. Quick, efficient delivery to these customers is facilitated by Citgo's various ownership interests in 39 refined product terminals with total storage capacity of approximately 17 million barrels, and exchange agreements that provide access to 310 other terminals in strategic locations. Citgo also has ownership interests in more than 15,000 miles of crude oil and refined product pipelines that provide a stable source of income.

Citgo continued to increase both the availability and visibility of its branded gasoline in 1986. About 7,000 retail outlets, including 2,700 7-Eleven stores, now display the Citgo brand and accept the "Citgo Plus" credit card. Aggressive promotions that added over one million new credit card accounts during the year and a new electronic point-of-sale credit card authorization system are key factors aimed at building the benefits of a major brand with the cost structure of an independent refiner/marketer — a large advantage in attracting new branded distributors.

In February 1987, Citgo began introducing its new gasoline detergent additive, "CDX-100," supported by extensive advertising. Also, Citgo plans to phase in gradually a three-grade slate of unleaded gasoline, which substitutes a mid-octane unleaded product for leaded regular gasoline. These programs follow Citgo's marketing strategy of targeting customers who are more brand-loyal and more likely to purchase higher-margin premium products.

Citgo's fully integrated lubricants business makes 350 products for a variety of customers. The operation includes 65-percent ownership of the Cit-Con lubricants refinery at Lake Charles, the fifth largest of its type in the country, which is supplied with feedstock from Citgo's adjacent light fuels refinery. Cit-Con's production of base oil stocks is blended into finished products and packaged at Citgo's wholly owned blending and packaging plant in Cicero, Illinois, as well as various contract packaging plants throughout the country. Citgo's finished lubricants sales grew 6.7 percent in 1986, the second consecutive year of declining industry demand, due to efforts specifically targeted at increasing this high-margin, relatively stable part of its business. Profitability was higher than normal in 1986, as feedstock costs declined much more sharply than lubricants prices during the first nine months of the year.

Since Citgo introduced convenient funnel-top plastic bottles several years ago, plastic has become the industry packaging standard. As a result, the Cicero plant will add a production line in 1987 that will more than double its plastic container-filling capability.

Citgo's industrial products business markets propane, propylene, petroleum coke, sulfur, residual fuel oil and other refinery products to a wide variety of domestic and international customers.

Customers like the convenience of the "Citgo Plus" credit card, now accepted at 7,000 retail outlets including 2,700 7-Eleven stores. Aggressive promotion attracted over one million new accounts in 1986.

Citgo supplies six percent of the nation's aviation turbine fuel through distribution to national and regional airlines at 21 major airports.

Citgo substantially increased its market share for finished lubricants during the year, partly due to innovative packaging ideas such as this six-pack of motor oil.

Citgo's refinery at Lake Charles, Louisiana, is the eighth largest in the country and is particularly well-suited to refine Venezuela's heavy sour crude oil. Since February 1986, Citgo has benefited from a long-term agreement with PDVSA for minimum shipments of 130,000 barrels per day of crude oil and other feedstocks at market-related prices.

SELECTED FINANCIAL DATA

(Dollars in millions, except per-share data)	1986	1985	1984	1983	1982	1981
Operations						
Net sales	$8,577.8	$8,578.5	$7,998.2	$7,172.1	$6,217.7	$5,608.8
Other income	41.9	43.9	42.5	21.8	21.9	40.5
Total revenues	8,619.7	8,622.4	8,040.7	7,193.9	6,239.6	5,649.3
Increase over prior year	—	7.2%	11.8%	15.3%	10.4%	18.1%
Net earnings	200.4	212.5	160.3	131.8	108.1	92.9
Increase over prior year	(5.7)%	32.6%	21.6%	21.9%	16.4%	21.4%
Per revenue dollar	2.3%	2.5%	2.0%	1.8%	1.7%	1.6%
Interest coverage ratio	5.15	5.88	4.01	4.76	5.07	4.47
Return on average shareholders' equity	13.0%	16.1%	14.2%	15.4%	16.6%	16.1%
Assets Employed						
Working capital	(205.7)	(391.6)	(152.4)	(9.6)	30.8	133.1
Current ratio	0.78	0.62	0.78	0.98	1.07	1.32
Property, plant and equipment	2,272.6	1,722.5	1,477.4	1,272.8	1,132.8	949.4
Depreciation and amortization	185.5	163.7	147.9	137.1	118.7	100.8
Total assets	3,421.1	3,233.5	2,549.0	2,245.2	1,793.3	1,605.5
Capitalization						
Long-term debt	639.5	575.6	564.0	540.0	565.2	527.6
Shareholders' equity	1,667.8	1,496.8	1,195.7	1,075.0	703.3	612.2
Total capitalization	2,307.3	2,072.4	1,759.7	1,615.0	1,268.5	1,139.8
Debt-to-equity ratio	0.40	0.40	0.49	0.53	0.84	0.90
Per-Share Data — Common Stock						
Primary earnings	3.96	4.41	3.41	3.26	3.02	2.61
Earnings assuming full dilution	3.91	4.37	3.38	3.21	2.94	2.54
Cash dividends	1.12	1.00	0.92	0.84	0.77	0.70
Shareholders' equity at year-end	31.91	28.84	25.39	22.94	19.48	17.23
Other Data						
Cash dividends — common stock	53.9	47.4	43.2	35.3	27.7	24.9
Dividends on common stock as a % of prior-year net earnings	25.3%	29.6%	32.8%	32.7%	29.8%	32.5%
Cash dividends — preferred stock	10.0	2.2	—	—	—	—
Average common shares outstanding (000s)	48,094.2	47,399.7	46,972.0	40,393.1	35,772.7	35,513.5
Average diluted shares (000s)	51,249.4	48,651.5	47,501.4	41,146.3	36,970.1	36,899.1
Market price range:						
High	60½	50	36½	48¼	31½	23⅜
Low	40⅜	24¾	23	25⅛	17	13⅝
Year-end	47	44	27⅛	32⅛	25⅞	21⅛
Number of shareholders of record — common stock	8,317	8,186	8,927	8,568	7,532	7,336
Number of employees	67,200	59,800	57,300	52,500	49,600	49,600

On September 30, 1986, the Company sold 50 percent of the common stock of its Citgo Petroleum Corporation (Citgo) subsidiary to a subsidiary of Petroleos de Venezuela, S.A. (PDVSA), for $290 million cash. A pretax capital gain of $114.7 million resulting from the sale was recognized in 1986. The financial statements for all periods prior to September 30, 1986, have been restated to record Southland's interest in Citgo under the equity method of accounting. Accordingly, through September 30, 1986, 100 percent of Citgo's pretax results are shown as a single-line item on the consolidated statements of earnings (see Note 2 to consolidated financial statements). Subsequent to September, only 50 percent of Citgo's net earnings are recorded by the Company, reflecting the change in its ownership of Citgo.

The sale and financing, the accompanying crude supply agreements between Citgo and PDVSA, and the gasoline supply agreement between Citgo and Southland accomplished several important objectives. The volatility of Citgo's earnings has been lessened and Southland's investment in and advances to Citgo have been reduced, while the original purpose of the Citgo acquisition — providing a reliable, economic supply of gasoline to 7-Eleven — has been maintained.

The resulting restatement of the balance sheets and statements of earnings has created several changes, none of which has affected Southland's prior-year earnings or shareholders' equity. For example, Citgo's revenues are no longer included and Southland's revenues, which were reported last year as $12.79 billion, have, upon restatement, been reduced to $8.62 billion. Similarly, Citgo's debt is no longer consolidated and Southland's 1985 year-end debt-to-equity ratio has been revised downward, from 0.47 to 0.40.

Also at the end of 1985, Southland's working capital was reported as $209 million. Since Citgo's inventory accounted for a large portion of this amount, the restated 1985 year-end working capital became a negative $392 million. The Company's ability to manage its cash position on a daily basis, the immediate availability of substantial amounts of funds in the short-term debt markets and the optimal use of trade credit allow it to operate comfortably with negative working capital while minimizing interest costs.

Balance Sheet

In addition to the restatements explained above, the sale of half of Citgo resulted in several significant changes to the balance sheet. Prior to the sale, Southland funded Citgo's working capital requirements primarily through the use of commercial paper. These advances reached a high of $447 million in February 1986. Subsequent to the sale, Southland's funding of Citgo was reduced to a $100-million subordinated loan. Citgo's additional working capital requirements are being met by a matching $100-million subordinated loan from PDVSA and by a secured $500-million revolving bank line of credit, which is nonrecourse to Southland. Citgo's borrowings under this line of credit totaled $225 million at December 31, 1986.

The restated current ratio improved during 1986 while the debt-to-equity ratio remained unchanged. The improvement in the current ratio was due primarily to higher inventories and reduced short-term debt levels. The interest coverage ratio decreased primarily due to the decline in pretax earnings.

Acquisitions

In December 1986, Southland acquired the operating assets of the Capitol Milk Producers Cooperative, Inc. The transaction included 346 High's Dairy Stores, located primarily in Virginia and Maryland, and two dairy facilities that process milk and manufacture ice cream, frozen novelties and a variety of cultured products and juices. Throughout the year, the Company made several other smaller acquisitions in its existing businesses.

Sources of Funds

Southland's operations continue to produce a high level of cash flow to fund capital expenditures, which is supplemented as necessary by outside financing. Funds provided from operations of $386 million equaled 49 percent of the total capital expenditures for the year.

The other major source of funds in 1986 was the sale and refinancing of Citgo.

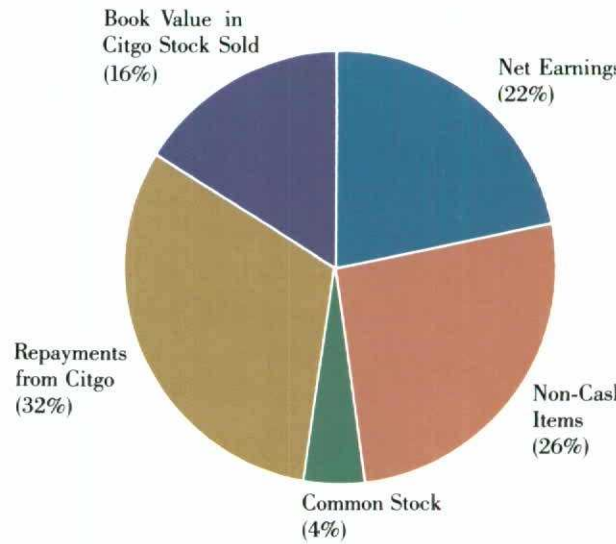
Uses of Funds

Because of confidence in the future of its core business, the Company invested $385 million in 7-Eleven stores during 1986. Of this amount, $210 million was for new store development, which included the completion of 439 new 7-Eleven stores, as well as 189 stores under construction at year-end, 35 more than at the end of 1985. In addition, the Company more than doubled to $175 million its expenditures for remodeling of stores and investment in the introduction of new marketing programs. Additional expenditures for the convenience retailing segment were made for several acquisitions and to support the continuing expansion of the distribution and auto parts retailing divisions.

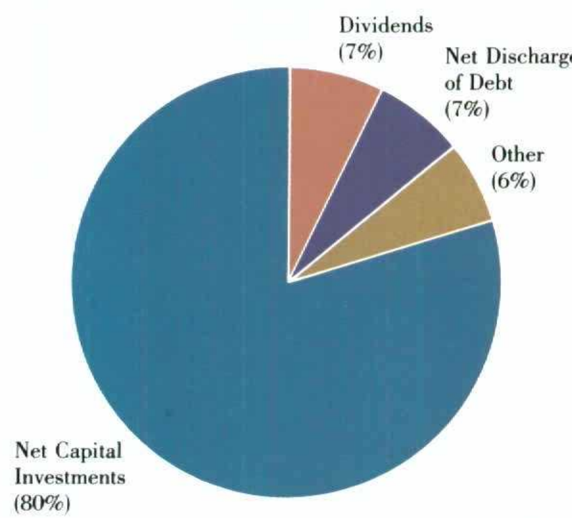
Another major capital expenditure was $123 million for Cityplace, including construction in progress on the Company's new headquarters building, which represented a major portion of the total corporate capital expenditures. In addition, $55 million was invested in acquisitions, remodeling and expansion in the food processing and manufacturing segment.

Capital expenditures for the convenience retailing segment and other existing businesses are expected to remain at their current level in 1987. It is anticipated that capital expenditures required for maintenance and remodeling of existing facilities and controlled expansion will be funded by a combination of internally generated funds and outside financing.

Sources of Funds — 1986



Uses of Funds — 1986



Construction of the Company's headquarters building will continue in 1987 with completion scheduled in 1988. Construction of the remainder of the 24-acre Cityplace Center office complex will proceed as real estate market conditions permit. The balance of the 160-acre Cityplace project, a mixed-use development adjacent to the corporate complex, will be developed over the next two decades, as conditions warrant.

Dividends on common stock paid to shareholders in 1986 totaled $53.9 million or $1.12 per share. In January 1987, the Board of Directors continued the current annual dividend rate.

Dividends paid on the Company's Series A Cumulative Convertible Exchangeable Preferred Stock during 1986 were $10 million or $4.00 per share.

Effective Tax Rate

The Tax Reform Act is not expected to have any significant effect on future financial results. The reduction in the federal tax rate resulting from the Tax Reform Act of 1986 is expected to more than offset the loss of the investment tax credit deduction. The Company expects its overall effective tax rate to be approximately 40% in 1987 and 33% in 1988, significantly higher than in prior years, since the remaining tax benefits previously provided by Citgo are no longer directly available to the Company.

Financing Activities

Commercial paper continues to be an attractive funding source available to the Company. It provides a flexible approach to cash planning and financing and is especially advantageous because of the seasonal nature of Southland's business. Commercial paper has also been available to the Company at a lower cost than other forms of financing. At year-end, when seasonal cash requirements were near their peak, $327.7 million of commercial paper was outstanding. The average balance during the year was approximately $255 million. Southland's commercial paper is backed by a long-term credit facility and the Company anticipates that at least $200 million will be outstanding throughout 1987. As a result, that amount is classified as long-term debt.

Capital and operating leases are important alternatives available to Southland for new store development. Additional transactions are anticipated in 1987.

In March 1987, Cityplace Center East Corporation, a subsidiary of the Company, issued $290 million of 7⅞% notes due February 1995 in connection with construction of its new headquarters building. The notes are nonrecourse to Southland (see Note 8 to the consolidated financial statements). A portion of the funds was used to retire commercial paper borrowings that had served as interim financing for Cityplace Center, and the balance will be applied toward the remaining construction costs. The cost of the headquarters complex, which includes the land, building, adjacent plazas, parking facilities adequate for future needs, architectural and design expenses, capitalized interest, and associated utility and road improvements, is expected to total $400 million.

Other Sources of Credit

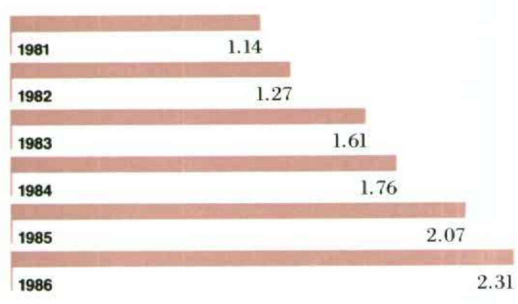
The Company maintains other credit facilities to fund additional requirements, as well as to back up its commercial paper borrowings.

One of these facilities is a $400-million revolving line of credit with 17 American and Canadian banks. In February 1987, Southland increased to $365 million its revolving line of credit with a consortium of major European, Canadian and Japanese banks. There were no borrowings under either facility during 1986.

The Company has also arranged for $285 million in uncommitted bank lines and master notes that can be used on short notice. At year-end, the Company had drawn $87.6 million under these arrangements, leaving $197.4 million available.

Additionally, in 1986 the Company maintained $10-million Canadian committed and $20-million Canadian uncommitted lines of credit. There were no borrowings against these lines in 1986. The committed line was cancelled in February 1987.

Total Capitalization *(Dollars in Billions)*



Credit Ratings

Southland's long-term debt is rated investment grade — "BBB" by Standard and Poor's, "Baa1" by Moody's and "7" by Duff and Phelps. The Company's commercial paper is rated "A-2," "P-2" and "1-" by those agencies, respectively. Canadian notes are rated "A" by the Canadian Bond Rating Service.

MANAGEMENT'S REVIEW OF OPERATING RESULTS

Revenues

Revenues (net sales of products and services, including sales by 7-Eleven stores operated by franchisees, and other income) declined slightly in 1986 due to the sharp decline in retail gasoline prices.

Revenues	1986	% Change	1985	% Change	1984	% Change
(millions)						
Net Sales:						
Convenience retailing	$7,999.3	(0.7)	$8,054.9	6.7	$7,552.6	11.5
Food processing and manufacturing	572.0	10.5	517.5	16.6	443.6	12.1
Corporate	6.4	6.5	6.1	216.6	1.9	114.7
Total sales	8,577.7	—	8,578.5	7.3	7,998.1	11.5
Other income	42.0	(4.6)	43.9	3.3	42.6	95.5
TOTAL	$8,619.7	—	$8,622.4	7.2	$8,040.7	11.8

The convenience retailing segment accounted for 93.3% of total sales in 1986, compared to 93.9% in 1985 and 94.4% in 1984. 7-Eleven and other convenience stores represented 86.1% or $7.39 billion of total sales in 1986, compared to 86.8% or $7.45 billion in 1985, and 82.6% or $6.61 billion in 1984. Lower sales in 1986 were due solely to the decline in retail gasoline prices.

Merchandise sales accounted for 76.7% of the convenience stores' sales in 1986, compared to 70.7% in 1985 and 73.3% in 1984.

Convenience Stores — Merchandise	1986	% Change	1985	% Change	1984	% Change
Sales (millions)	$5,668.1	7.7	$5,264.7	8.7	$4,844.8	9.4
Number of stores	8,181*	5.7	7,743	(0.6)	7,790	6.2

**Number includes 346 High's Dairy Stores, of which 83 sell gasoline. Because these stores were not acquired until December 30, 1986, their sales and operating results are not included.*

More efficient use of selling space, increased advertising, new products and services, and traffic-building competitive pricing of selected items such as milk, beer, carton cigarettes and soft drinks, contributed to the increase in merchandise sales and resulted in real growth of 3.7%, 4.3% and 3.7% in stores open more than one year. The net addition of 153, 46 and 174 7-Eleven stores in 1986, 1985 and 1984 also contributed to the sales increase.

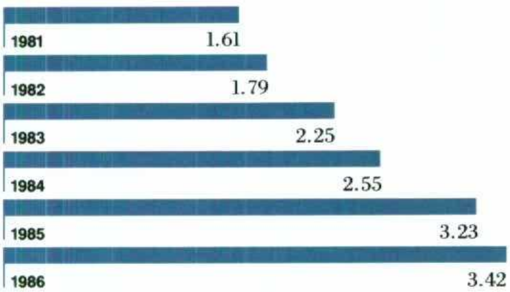
Self-serve gasoline, the largest single product category in the convenience stores' sales mix, was 23.3% of 1986 sales, compared to 29.3% in 1985 and 26.7% in 1984.

Gasoline sales declined in 1986, despite increases in both the number of stores selling gasoline and the average gallonage sold per store, due to the sharp decline in retail prices.

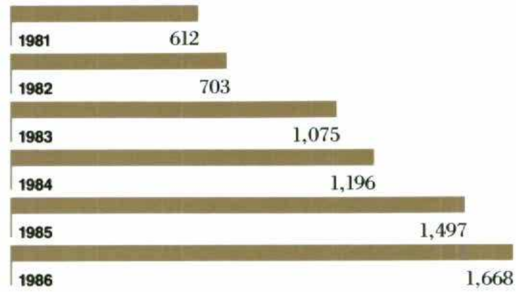
Convenience Stores — Gasoline	1986	% Change	1985	% Change	1984	% Change
Sales (millions)	$1,720.1	(21.2)	$2,183.3	23.8	$1,763.3	11.7
Gallons (millions)	2,048.8	4.3	1,965.2	22.2	1,608.3	13.4
Gross profit (millions)	$ 193.2	29.9	$ 148.7	30.0	$ 114.4	34.9
Gross profit per gallon (cents)	9.4	24.6	7.6	6.5	7.1	18.9
Number of stores	3,594*	4.2	3,449	(2.2)	3,525	15.8

Other income declined slightly in 1986, despite increases in interest income and area license royalties, as gains from the sale of assets no longer used in the business decreased. In 1985 other income remained relatively flat as gains from the sale of assets were offset by less gains from the repurchase of debentures to meet sinking fund requirements. In 1984 other income rose 95.5%, primarily due to more gains from the sale of assets and the repurchase of debentures, and higher interest income.

Total Assets *(Dollars in Billions)*



Total Shareholders' Equity *(Dollars in Millions)*



Gross Profits and Margins

Gross profits (sales less cost of goods sold) were up 7.0%, 7.3% and 11.6% while sales were unchanged in 1986 and increased 7.3% in 1985 and 11.5% in 1984. The impact of inflation was not significant on Southland's gross profits all three years due to the low rates of inflation. For the periods, gross margins (gross profits divided by sales) were:

Gross Margins *(percentage)*	1986	1985	1984
First quarter	22.77	20.20	20.05
Second quarter	23.80	21.97	22.26
Third quarter	23.86	22.63	22.07
Fourth quarter	21.54	20.97	21.37
YEAR	23.02	21.51	21.49

Gross margins increased in 1986 due to significantly higher gasoline margins and improved performances from the dairy and distribution operations.

The overall convenience stores' gross margin increased in 1986 due to the higher gasoline margins that more than offset a decline in merchandise margins. The decline in merchandise margins resulted from the continuing economic recession in many southern and midwestern markets that depend heavily upon the depressed energy, construction and agricultural industries. In addition, the competitive pricing strategy in certain markets contributed to the decline. In 1985 the convenience stores' gross margin declined due to lower merchandise margins, which resulted primarily from more aggressive promotional programs in divisions serving Houston and other Gulf Coast areas. In 1984 the gross margin improved as a result of higher retail gasoline and merchandise margins.

Selling, General and Administrative Expenses

In 1986, 1985 and 1984, selling, general and administrative expenses increased 7.2%, 9.7% and 12.7%. The ratios of these expenses to sales were:

Selling, General and Administrative Expenses *(percentage)*	1986	1985	1984
First quarter	20.05	19.35	19.16
Second quarter	20.29	18.40	18.63
Third quarter	20.19	18.82	18.35
Fourth quarter	20.98	19.54	18.29
YEAR	20.38	19.00	18.59

Lower sales resulting from the decline in retail gasoline prices and higher expenses caused selling, general and administrative expenses as a percent of sales to increase 1.38 percentage points to 20.38% in 1986. The financing costs associated with the sale of accounts receivable and increased insurance expenses caused the ratio of these expenses to sales to increase in 1985. In 1984, due to the growth in retail gasoline sales, this ratio showed only a slight increase.

Interest and Imputed Interest Expense

Interest expense in 1986 remained at 1985 levels, because lower interest rates and increases in capitalized interest offset the effects of higher average debt levels. The increase in 1984 was primarily attributable to Southland's funding of Citgo's working capital requirements. Imputed interest expense increased 6.1% in 1986, following declines of 0.8% in 1985 and 3.2% in 1984, reflecting increased use of capital leases.

Equity in Earnings of Citgo

Equity in earnings (loss) of Citgo declined $164.7 million in 1986. The negative comparison with 1985 was due to a net $112 million pretax non-cash inventory charge recorded by Citgo in 1986 and a decline in operating earnings resulting from extremely poor results in the first quarter. In 1985 equity in earnings of Citgo increased $138.5 million, while in 1984 it decreased $37.1 million. The fluctuations in Citgo's earnings during these years were the result of the prevailing conditions in the petroleum refining and marketing industry.

Income Taxes

The effective income tax rates of 18.5% in 1986, 24.7% in 1985 and 7.0% in 1984 were below the federal statutory rate of 46% primarily due to tax benefits arising from Citgo. The reduction in the effective rate in 1986 was attributed to Citgo's loss and the reduced tax rate on the $114.7-million capital gain realized from the sale of half of Citgo.

Net Earnings

Earnings increased 8.0% before income taxes and any effect of Citgo. However, equity in loss of Citgo was only partially offset by the gain on the sale of half of Citgo and lower income taxes, which resulted in net earnings declining $12.1 million or 5.7% in 1986. Citgo's improved performance in 1985 contributed to increased earnings, while tax benefits arising from Citgo contributed to the increase in 1984.

Management's Responsibility for Financial Reporting

The consolidated financial statements of The Southland Corporation and subsidiaries, as well as other financial information contained in this report, were prepared by management, which is responsible for their integrity and objectivity.

The Company's financial position and results of operations are presented in conformity with generally accepted accounting principles and, where appropriate, reflect estimates based on judgments of management. The Company has designed and implemented accounting and reporting systems and controls to provide reasonable assurance that transactions are accurately reflected in the books and records, assets are protected, established policies and procedures are followed, and the Company's financial position and results of operations are presented fairly. Accounting and reporting controls are monitored through an extensive program of internal audits by a professional staff of Company auditors that coordinates its activities with the Company's independent certified public accountants.

Touche Ross & Co. is engaged to examine the consolidated financial statements and issue its report thereon. Its examination is conducted in accordance with generally accepted auditing standards, including a review of internal controls and such tests of the accounting records as it considers necessary.

The Board of Directors, assisted by its Audit Committee of four non-employee directors, is responsible for assuring that management fulfills its responsibilities in the preparation of the financial statements and for recommending to shareholders the engagement of the independent certified public accountants, with whom the Committee reviews the scope of the audit and the accounting principles to be applied in financial reporting. The Committee meets as necessary, but at least three times a year. Touche Ross & Co. and the Company's internal auditors have direct access to the Committee — with or without the presence of management — to discuss any appropriate matter.

Clark J. Matthews II

Clark J. Matthews, II
Senior Executive Vice President
and Chief Financial Officer

Independent Auditors' Report

Board of Directors and Shareholders
The Southland Corporation
Dallas, Texas

We have examined the consolidated balance sheets of The Southland Corporation and subsidiaries as of December 31, 1986 and 1985, and the related consolidated statements of earnings, shareholders' equity and changes in financial position for each of the three years in the period ended December 31, 1986. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the consolidated financial statements referred to above present fairly the financial position of The Southland Corporation and subsidiaries at December 31, 1986 and 1985, and the results of their operations and the changes in their financial position for each of the three years in the period ended December 31, 1986, in conformity with generally accepted accounting principles applied on a consistent basis after restatement for the change, with which we concur, to account for the investment in Citgo on the equity method as described in Note 2 of notes to the consolidated financial statements.

Touche Ross & Co

Dallas, Texas
February 20, 1987

Certified Public Accountants

CONSOLIDATED BALANCE SHEETS

The Southland Corporation and Subsidiaries

(Dollars in thousands, except per-share data) December 31	1986	1985
Assets		
Current assets:		
Cash and short-term investments	$ 71,600	$ 74,688
Accounts and notes receivable	165,738	106,806
Inventories	435,129	353,916
Deposits and prepaid expenses	47,044	49,918
Investment in properties	27,300	61,500
Total current assets	746,811	646,828
Property, plant and equipment	2,272,624	1,722,496
Investment in and advances to Citgo	286,584	800,904
Other assets	115,069	63,290
	$3,421,088	$3,233,518
Liabilities and Shareholders' Equity		
Current liabilities:		
Commercial paper and notes payable to banks	$ 215,291	$ 296,620
Accounts payable and accrued expenses	633,899	570,520
Accounts payable to Citgo	53,528	98,866
Income taxes	23,975	50,513
Long-term debt due within one year (including $3,128 and $3,000 due to related parties)	25,848	21,890
Total current liabilities	952,541	1,038,409
Deferred credits and other liabilities	161,220	122,700
Long-term debt (including $34,798 and $38,315 due to related parties)	639,496	575,586
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, 5,000,000 shares authorized:		
Series A Cumulative Convertible Exchangeable Preferred Stock; $50 per share stated and liquidation value; 2,500,000 shares, being all of Series A, issued and outstanding	125,000	125,000
Common stock, $.01 par value; 150,000,000 shares authorized, 48,353,999 and 47,566,413 shares issued and outstanding	484	476
Additional capital	676,224	639,871
Retained earnings	866,123	731,476
Total shareholders' equity	1,667,831	1,496,823
	$3,421,088	$3,233,518

See notes to consolidated financial statements.

Consolidated Statements of Earnings

The Southland Corporation and Subsidiaries

(Dollars in thousands, except per-share data) Year ended December 31	1986	1985	1984
Revenues:			
Net sales	$8,577,749	$8,578,454	$7,998,145
Other income	41,932	43,943	42,528
	8,619,681	8,622,397	8,040,673
Cost of sales and expenses:			
Cost of goods sold (including $983,609, $1,566,691 and $1,191,862 from related parties)	6,603,164	6,733,464	6,279,459
Selling, general and administrative expenses	1,747,856	1,630,269	1,486,742
Interest expense	38,256	38,050	37,227
Imputed interest expense on capital lease obligations (including $3,683, $4,080 and $4,403 to related parties)	21,029	19,825	19,987
Contributions to Employees' Savings and Profit Sharing Plan	26,170	31,213	19,130
	8,436,475	8,452,821	7,842,545
	183,206	169,576	198,128
Equity in earnings (loss) of Citgo	(51,993)	112,675	(25,814)
Gain from sale of half-interest in Citgo	114,732	—	—
Earnings before income taxes	245,945	282,251	172,314
Income taxes	45,500	69,716	12,062
Net earnings	$ 200,445	$ 212,535	$ 160,252
Earnings per common share:			
Primary	$3.96	$4.41	$3.41
Fully diluted	$3.91	$4.37	$3.38

See notes to consolidated financial statements.

Consolidated Statements of Changes in Financial Position

The Southland Corporation and Subsidiaries

(Dollars in thousands) Year ended December 31	1986	1985	1984
Internally generated funds:			
Net earnings	$ 200,445	$ 212,535	$ 160,252
Non-cash items:			
Depreciation and amortization	185,522	163,651	147,878
Deferred income taxes	(1,887)	(2,771)	30,741
Equity in (earnings) loss of Citgo	58,896	(73,002)	23,561
	442,976	300,413	362,432
Increase in accounts payable and accrued expenses	63,379	79,429	52,503
(Decrease) increase in accounts payable to Citgo	(45,338)	47,515	(10,417)
Decrease (increase) in deposits and prepaid expenses	4,434	(1,015)	6,720
Increase in inventories	(81,213)	(77,004)	(10,197)
(Increase) decrease in accounts and notes receivable	(18,018)	(13,803)	23,958
(Decrease) increase in income taxes	(26,538)	62,357	(21,238)
Increase (decrease) in deferred credits and other liabilities	46,478	24,135	(233)
Funds provided from operations	386,160	422,027	403,528
Funds used to pay dividends on common stock	(53,877)	(47,405)	(43,215)
Funds used to pay dividends on preferred stock	(10,000)	(2,150)	—
Net change in accumulated foreign currency translation adjustment	760	4,418	(2,179)
Net internally generated funds available for investment	323,043	376,890	358,134
Capital investment activities:			
Acquisitions:			
Property, plant and equipment	(688,683)	(445,972)	(381,879)
Net noncurrent assets of businesses acquired	(98,215)	(18,882)	(9,598)
Investment in properties	34,200	7,900	6,800
Other	(32,290)	17,980	5,098
	(784,988)	(438,974)	(379,579)
Retirements of property, plant and equipment	46,060	49,354	38,278
Investment in and advances to Citgo	299,979	(272,562)	(143,704)
Sale of half-interest in Citgo	147,814	—	—
Net funds used by capital investment activities	(291,135)	(662,182)	(485,005)
Financing activities:			
Financing acquired:			
Commercial paper and notes payable to banks	(31,329)	174,380	171,802
Long-term debt	38,220	59,137	11,202
Sale of accounts receivable	(40,914)	1,289	39,625
Preferred stock	—	120,926	—
Common stock	33,680	12,812	5,867
	(343)	368,544	228,496
Discharge of long-term debt (including $3,390, $5,007 and $2,738 to related parties)	(34,653)	(51,763)	(63,695)
Net funds (used in) provided by financing activities	(34,996)	316,781	164,801
(Decrease) increase in cash and short-term investments	$ (3,088)	$ 31,489	$ 37,930

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

The Southland Corporation and Subsidiaries

(Dollars in thousands, except per-share data) Year ended December 31	1986	1985	1984
Preferred stock:			
Balance, end of year	$ 125,000	$ 125,000	$ —
Common stock:			
Balance, beginning of year	476	471	469
Conversion of debt	1	2	1
Stock options, incentives and other	7	3	1
Balance, end of year	484	476	471
Additional capital:			
Balance, beginning of year	639,871	630,517	624,483
Conversion of debt	2,150	5,012	3,122
Stock options, incentives and other	34,203	4,342	2,912
Balance, end of year	676,224	639,871	630,517
Retained earnings:			
Balance, beginning of year	731,476	564,699	450,010
Net earnings	200,445	212,535	160,252
Cash dividends:			
Common stock ($1.12 per share in 1986)	(53,877)	(47,405)	(43,215)
Preferred stock ($4.00 per share in 1986)	(10,000)	(2,150)	—
Stock options	(2,681)	(621)	(169)
Foreign currency translation adjustment	760	4,418	(2,179)
Balance, end of year	866,123	731,476	564,699
Total shareholders' equity	$1,667,831	$1,496,823	$1,195,687

See notes to consolidated financial statements.

1. Accounting Policies:

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries. Intercompany transactions are eliminated.

The Company's investment in Citgo Petroleum Corporation (Citgo) is accounted for by the equity method. Accordingly, this investment is shown on the consolidated balance sheets at cost to the Company plus equity in undistributed earnings (see Note 2). Equity in earnings (loss) of Citgo on the consolidated statements of earnings represents, after elimination of intercompany interest, the Company's 100% interest in Citgo through September 30, 1986, and its 50% interest after that date.

Financial information provided by Citgo, not including eliminations recorded in the Company's consolidated financial statements, is summarized as follows:

December 31	1986	1985
(Dollars in thousands)		
Summary of financial position:		
Current assets	$ 826,123	$ 894,856
Noncurrent assets	382,474	380,138
	$1,208,597	$1,274,994
Current liabilities	$ 307,191	$ 462,185
Noncurrent liabilities	562,280	550,067
Shareholders' equity	339,126	262,742
	$1,208,597	$1,274,994

Year ended December 31	1986	1985	1984
(Dollars in thousands)			
Summary of operating results:			
Revenues	$4,132,129	$5,716,024	$5,232,234
Gross profit	114,008	181,850	91,985
Earnings (loss) before income taxes	6,191	52,180	(36,354)
Net earnings (loss)	43,578	39,291	(33,661)

Prior to September 30, 1986, Citgo was included in the Company's consolidated income tax return. For financial reporting prior to January 1, 1986, the Company allocated tax expense (benefit) to Citgo based on pretax earnings (loss) using the Company's consolidated effective tax rate. In connection with its negotiations to sell 50% of the common stock in Citgo, the Company agreed to pay Citgo certain of the tax benefits related to Citgo and utilized in the Company's consolidated tax return for the period from January 1, 1986, through September 30, 1986. The amount of these tax benefits was approximately $50 million and has been included as a tax benefit in Citgo's operating results for 1986. The allocation of intercompany taxes had no effect on the Company's reported earnings. If taxes for Citgo for the years ended December 31, 1986, 1985 and 1984, had been calculated on a stand-alone basis as if Citgo had not been a subsidiary of the Company, pro forma net earnings (loss) for Citgo for those years would have been $7,354,000, $59,700,000 and ($35,664,000).

During the fourth quarter of 1986, Citgo changed its method of accounting for crude oil inventories from the first-in, first-out (FIFO) method to the last-in, first-out (LIFO) method, effective as of January 1, 1986, for financial reporting purposes and as of October 1, 1986, for tax purposes. This accounting change had no effect on the Company's reported earnings for the year ended December 31, 1986.

Revenues

Net sales are comprised of sales of products and services, including sales by stores operated by franchisees of $2,529,157,000, $2,287,554,000 and $2,042,549,000 for the years ended December 31, 1986, 1985 and 1984. There is no significant difference in the profitability of a Company-operated and a franchisee-operated store.

Sales by stores operated under domestic and foreign area license agreements are not included. All fees or royalties arising from such agreements are included in other income. Initial fees, which have been immaterial, are recognized when the services required under the agreements are performed.

Other income is primarily comprised of area license royalties, gains from the sale of assets no longer used in the business and interest on short-term investments.

Cost of Goods Sold

Cost of goods sold includes, for the convenience retailing segment, buying and occupancy expenses.

Inventories

Inventories are stated at the lower of cost or market, which, as to merchandise in stores, is determined by the retail inventory method. Cost is determined using the LIFO method for substantially all inventories (including gasoline) of the convenience retailing segment and the FIFO method for all other inventories.

The cost of manufactured or processed finished goods inventory includes the costs of purchased materials, direct labor and manufacturing overhead.

Investment in Properties

Investment in properties includes land, buildings and equipment to be sold for cash and leased back under operating lease agreements, as well as closed stores held for sale. The Company expects that cash will be realized for these properties within a 12-month period. Working capital is used in the acquisition, construction and carrying of these assets.

Depreciation and Amortization

Depreciation of plant and equipment is based upon the estimated useful lives of these assets using the straight-line method. Amortization of capital leases and improvements to leased properties is based upon the remaining terms of the leases or the estimated useful lives, whichever is shorter.

Excise Taxes

Excise taxes of $390,833,000, $336,872,000 and $283,709,000 collected from customers on retail gasoline sales are included in net sales and cost of goods sold for the years ended December 31, 1986, 1985 and 1984.

Income Taxes and Investment Tax Credits

Income taxes are the estimated amount of federal and state income taxes on earnings reported in the consolidated statements of earnings. Deferred taxes and deferred tax benefits are provided for and are a result of timing differences between financial and tax reporting.

Investment tax credits are recorded as a reduction of income taxes in the year the related assets are placed in service (see Note 12).

Leases

Capital leases are recorded at the inception of the lease at the lower of the discounted present value of future minimum lease payments or the fair value of the property.

For closed leased stores, provision is made on a current basis if anticipated expenses are in excess of expected sublease rentals.

2. Sale of Half-interest in Citgo and Accounting Change:

As of September 30, 1986, the Company sold 50% of the common stock of Citgo to Propercit S.A. (Propercit), a wholly owned subsidiary of Petroleos de Venezuela, S.A. (PDVSA), the stock of which is owned by the Republic of Venezuela. The purchase price consisted of $290 million cash, of which $27.5 million was deferred because it was contingently repayable to Propercit on January 31, 1991, if the market prices of petroleum products do not increase sufficiently at any time prior to that date according to a formula in the Stock Purchase Agreement. The deferred gain was $23.3 million at December 31, 1986. In connection with the purchase, Citgo entered into a 20-year crude supply agreement with PDVSA to purchase a minimum of 130,000 barrels of crude oil per day at market-related prices, and the Company entered into a 20-year product purchase agreement with Citgo to buy specified quantities of gasoline at market-related prices (see Note 15).

The sale resulted in a gain to the Company during 1986 of $114.7 million before profit sharing expense of $11.4 million and income taxes of $14.7 million, for a net gain of $88.6 million, or $1.84 per primary share.

As a result of the sale of half of Citgo's equity, the Company changed the method of accounting for its investment in Citgo from full consolidation to the equity method of accounting in order to improve the comparability of prior-year results to 1986 and future years. The financial statements for all periods prior to September 30, 1986, have been restated to reflect the Company's ownership of Citgo on the equity method (100% through September 30, 1986). Income taxes and profit sharing contribution through September 30, 1986, are separately provided in the consolidated statements of earnings.

The effect of the restatement was a reduction in consolidated revenues and costs and expenses as follows:

	Nine months ended September 30 1986	Year ended December 31 1985	1984
(Dollars in thousands)			
Revenues	$2,504,086	$4,167,233	$4,064,328
Costs and expenses	2,576,406	4,054,558	4,090,142
Equity in earnings (loss) of Citgo	$ (72,320)	$ 112,675	$ (25,814)

3. Cash and Short-Term Investments:

Cash and short-term investments include temporary cash investments of $105,718,000 and $12,020,000 at December 31, 1986 and 1985, stated at cost, which approximates market.

4. Accounts and Notes Receivable:

December 31	1986	1985
(Dollars in thousands)		
Notes receivable (net of long-term portion of $15,387 and $16,503)	$ 10,207	$ 7,033
Trade accounts receivable	129,795	71,331
Franchisee accounts receivable	31,566	33,952
	171,568	112,316
Allowance for doubtful accounts	(5,830)	(5,510)
	$165,738	$106,806

Trade accounts receivable as of December 31, 1985, were reduced by approximately $41 million representing the sale of accounts receivable. This sales agreement was terminated during 1986.

5. Inventories:

At December 31, 1986 and 1985, inventories stated on the LIFO basis were approximately $283,408,000 and $240,670,000, which is less than replacement cost by approximately $83,124,000 and $87,780,000.

6. Property, Plant and Equipment:

December 31	1986	1985
(Dollars in thousands)		
Cost:		
Land	$ 308,528	$ 264,211
Buildings and leaseholds	1,252,160	1,060,036
Machinery and equipment	985,039	784,402
Vehicles	118,663	113,230
Construction in process	209,053	122,721
Property held for future Cityplace development	151,660	118,696
Cityplace construction in process	214,094	115,046
	3,239,197	2,578,342
Accumulated depreciation and amortization	(966,573)	(855,846)
	$2,272,624	$1,722,496

Interest incurred to finance the construction or development of properties, which has been added to the cost of the related assets, was $18,870,000 in 1986, $11,328,000 in 1985 and $6,428,000 in 1984.

In 1984 the Company commenced construction of a new corporate headquarters tower within Cityplace Center, the first stage of the Company's Cityplace mixed-use real estate development in Dallas, Texas. Remaining construction costs to complete the headquarters tower are expected to approximate $240 million.

7. Accounts Payable and Accrued Expenses:

December 31	1986	1985
(Dollars in thousands)		
Trade accounts payable	$329,635	$288,861
Accrued payroll	92,075	85,965
Accrued taxes	77,415	63,827
Other	134,774	131,867
	$633,899	$570,520

8. Debt:

December 31, 1986	Amount outstanding	Due within one year	Balance included in long-term debt
(Dollars in thousands)			
Commercial paper and notes payable to banks	$200,000	$ —	$200,000
8⅜% sinking fund debentures due 2002	24,351	—	24,351
9⅜% sinking fund debentures due 2003	42,307	2,400	39,907
9½% sinking fund debentures due 2004	60,915	—	60,915
12% Canadian notes due 1992	36,349	—	36,349
Real estate and equipment notes and other debt with a weighted average interest rate of 9.7% (mature 1987 to 2011)	94,173	9,573	84,600
Capital lease obligations	207,249	13,875	193,374
	$665,344	$25,848	$639,496

Commercial paper and notes payable to banks, both current and long-term, include $327.7 million of commercial paper and $87.6 million of notes payable to banks. Of this total, $200 million has been classified as long-term debt because the Company intends to maintain at least this amount of such debt for a minimum of one year or to refinance the debt on a long-term basis when advantageous to the Company, and has the availability of such refinancing because of the existence of the lines of credit discussed below. The average interest rate on commercial paper and notes payable to banks outstanding at December 31, 1986, is 6.55%, which is less than the interest rates available at that date under the revolving credit agreements.

Property, plant and equipment with a carrying value of approximately $83 million at December 31, 1986, was mortgaged under real estate, equipment and other notes.

Lenders to certain wholly owned real estate subsidiaries hold pledges of the shares of those subsidiaries as additional collateral.

The 12% Canadian notes due 1992 are redeemable at the option of the Company from July 1990 to July 1991 at 101½% of the principal amount and after July 25, 1991, until maturity at 100¾% of principal. Payments of interest and principal are denominated in Canadian dollars.

The Company has a revolving credit agreement with a syndicate of commercial banks providing for a line of credit of $400 million through December 31, 1988. The agreement provides for 16 equal quarterly payments of principal plus accrued interest beginning March 31, 1989, and provides for a commitment fee on unadvanced funds of ¼% per annum. The Company has another revolving credit agreement with a syndicate of European, Canadian and Japanese banks providing for a line of credit of $365 million through January 31, 1989. The agreement provides for eight equal quarterly payments of principal plus accrued interest beginning April 30, 1989, and provides for a commitment fee on unadvanced funds of ⅛% per annum. Both agreements include interest rate options based upon the certificate of deposit loan rate, Eurodollar loan rate (both of which generally are less than the prime rate) or the prime rate. Neither agreement requires the maintenance of compensating balances. No loans are outstanding under these agreements at December 31, 1986.

Subsequent to December 31, 1986, Cityplace Center East Corporation, a subsidiary of the Company, issued $290 million of notes in the public market to finance the construction of the headquarters tower, a parking garage and related facilities of the Cityplace Center development.

These notes bear interest at 7⅞%, payable semiannually, with the principal amount due February 15, 1995. Principal and interest on the notes are payable by drawings under irrevocable Letters of Credit issued by The Sanwa Bank, Limited, Dallas Agency, which, along with the noteholders, has been granted a lien on the property financed. This property has a carrying value of approximately $140 million at December 31, 1986. The Company will occupy the building as its corporate headquarters, and payments under its 15-year lease of the building and garage parking will be sufficient to cover interest on the debt and operating expenses.

During 1984, the Company entered into currency exchange agreements with two multinational financial institutions that converted $75 million of commercial paper borrowings into Japanese yen equivalents bearing interest at 7.7% on a quarterly payment basis, payable in Japanese yen for seven to 10 years. The Company has hedged these Japanese yen borrowings by designating its future royalty receipts from its area licensee in Japan to service interest and principal yen payments, thus offsetting the impact of exchange rate fluctuations. Accordingly, no foreign currency exchange rate gain or loss is recognized on these yen borrowings. The Company also has interest rate exchange agreements, which fix the interest rate on $150 million of floating rate debt at 11.7% on a semiannual payment basis until 1987.

As of December 31, 1986, long-term debt scheduled maturities, which include capital lease obligations and sinking fund requirements, are as follows:

(Dollars in thousands)	
1987	$ 25,848
1988	25,119
1989	78,447
1990	78,000
1991	78,210
Thereafter	379,720
	$665,344

9. Stock Options, Key Employees Incentive Plan and Preferred Stock:

Stock Options

The Employees Stock Option Plan, adopted in 1977 and amended in 1983, provides for the granting of options to key employees and officers of the Company. The options are generally granted at the fair market value of the shares on the date of grant.

Options granted under Part A of the plan expire 10 years from date of grant and are exercisable ratably over that period on a cumulative basis. Options granted under Part B of the plan expire at least two years, and not more than 10 years, from date of grant and are exercisable ratably over the period specified in the option on a cumulative basis.

Options granted under Part C of the plan qualify as incentive stock options under the Internal Revenue Code. These options will expire at least two years, and not more than 10 years, from date of grant and are exercisable ratably in the sequence granted over the period specified in the option.

Options granted under Parts A and B of the plan may include the right of the optionholder to receive, upon exercise of an option, a cash payment equal to the difference between the purchase price and the market price on the date of exercise. All applicable options granted under the plan through December 31, 1986, include such a right.

At December 31, 1986, there were options outstanding to acquire 1,734,109 shares at prices from $12.73 to $48.75 per share, with an average price of $38.82 per share, of which 248,837 were exercisable. Options outstanding will expire from 1987 to 1993. During the year ended December 31, 1986, options for 680,953 shares were exercised at $12.73 to $36.63 per share. At December 31, 1986, 3,089,032 shares were authorized for future issuance under this plan.

Key Employees Incentive Plan

At December 31, 1986, 286,835 shares were authorized for issuance pursuant to a key employees incentive plan. In 1986 and 1985, 42,095 and 49,562 shares were issued under the plan. No shares will be issued in 1987.

Preferred Stock

The Company has 5,000,000 shares of preferred stock authorized for issuance. Any preferred stock issued will have such rights, powers and preferences as determined by the Company's Board of Directors.

On August 29, 1985, the Company issued 2,500,000 shares of Series A Cumulative Convertible Exchangeable Preferred Stock with a stated and liquidation value of $50 per share. Dividends are cumulative at an annual rate of $4 per share and are payable quarterly. Under normal circumstances, Series A will have no voting rights.

Series A is redeemable at any time on or after August 15, 1988, in whole or in part, at the option of the Company at $52.80 per share, declining to $50 per share on August 15, 1995. Unredeemed shares are convertible at the option of the holder at any time into common stock, $.01 par value, at the rate of 1.1723 shares for each share of Series A. At December 31, 1986, 2,930,750 shares of common stock were reserved for such conversions.

Series A also is exchangeable in whole, at the option of the Company, beginning August 15, 1988, for 8% convertible subordinated debentures at the rate of $50 principal amount of debenture for each share of Series A. Each debenture will be convertible at any time prior to August 15, 2015, at the option of the holder, into 1.1723 shares of common stock.

On October 24, 1986, the Board of Directors adopted a Shareholder Rights Plan under which preferred stock purchase rights were distributed as a dividend at the rate of one right for each common share held as of the close of business on November 10, 1986. As long as the rights are attached to the common stock, the Company will issue one right for each share of common stock issued. Each right, which is not separable from the related share of common stock until distributed pursuant to the plan, entitles the holder to buy one one-hundredth of a share of Junior Participating Preferred Stock, Series B, from the Company at an exercise price of $175 in cash or shares of common stock. The rights are not exercisable until after a person or group (an Acquiring Person) has acquired 20% or more, or makes a tender or exchange offer for 30% or more, of the Company's common stock. If Southland is the surviving corporation in a merger with an Acquiring Person or if an Acquiring Person engages in certain self-dealing transactions with Southland, Series B will entitle a holder, other than the Acquiring Person, to acquire, upon exercise of the right, shares of the Company's common stock or, under certain circumstances, cash, other property or other securities having a value of twice the right's exercise price. In addition, if Southland is involved in a merger or other business combination and is not the surviving corporation, at any time when there is a 20%-or-more shareholder of the Company, the rights will entitle a holder to buy common stock of the acquiring company having a market value of twice the exercise price of each right. The Company will generally be entitled to redeem the rights at $.05 per right at any time until the fifteenth day (subject to extension) following a public announcement that a 20% position has been acquired. Unless redeemed earlier by Southland, the rights will expire on November 10, 1996. The Company has reserved 1,000,000 shares of preferred stock for issuance of Series B.

10. Employee Benefit Plans:

Employees' Savings and Profit Sharing Plan

Effective January 1, 1949, the Company adopted The Southland Corporation Employees' Savings and Profit Sharing Plan (Profit Sharing) for the purpose of providing retirement benefits for eligible employees.

Contributions to Profit Sharing are made by both the participants and the Company. The Company contributes approximately 10% of its net earnings, before contribution to Profit Sharing, contribution to the ESOP and federal income taxes. The Company contribution is allocated to the participants on the basis of their individual contribution, years of participation in Profit Sharing and age.

Employee Stock Ownership Plan

Effective January 1, 1983, the Company adopted the Southland Employee Stock Ownership Plan (the ESOP) for eligible employees. Contributions to the ESOP totaled $3,386,000, $3,031,000 and $2,841,000 for 1986, 1985 and 1984. The Company contribution is allocated to the participants on an equal basis and results in a federal tax credit of equal amount. The ESOP will be terminated effective January 1987.

Post-Retirement Insurance Benefits

Under a plan that covers both active and retired employees, the Company provides certain health care and life insurance benefits for retirees through a trust that is funded partially by their payments and the balance by the Company. Substantially all employees may become eligible for these retirement benefits if they reach normal retirement age or qualify for the Company's early retirement plan. The cost to the Company of retiree health care and life insurance benefits is recognized as expense as claims are incurred and was $1,909,000 and $1,442,000 in 1986 and 1985.

11. Leases:

Certain of the property, plant and equipment used in the Company's business is leased. Generally, real estate leases are for primary terms of from 14 to 20 years with options to renew for additional periods, and equipment leases are for terms of from five to 10 years. The leases do not contain restrictions that have a material effect on the Company's operations.

The composition of capital leases reflected as property, plant and equipment in the consolidated balance sheets is as follows:

December 31	1986	1985
(Dollars in thousands)		
Buildings	$ 290,597	$ 262,187
Equipment	46,304	52,087
	336,901	314,274
Accumulated amortization	(185,461)	(181,850)
	$ 151,440	$ 132,424

The present value of future minimum lease payments for capital lease obligations is reflected in the consolidated balance sheets as long-term debt. The amount representing imputed interest necessary to reduce net minimum lease payments to present value has been calculated generally at the Company's incremental borrowing rate at the inception of each lease.

Future minimum lease payments for years ending December 31 are as follows:

	Capital leases	Operating leases
(Dollars in thousands)		
1987	$ 34,829	$ 138,512
1988	33,581	116,168
1989	32,585	105,406
1990	31,679	99,844
1991	31,400	94,701
1992 and thereafter	236,617	690,509
Future minimum lease payments	400,691	$1,245,140
Estimated executory costs	(3,812)	
Amount representing imputed interest	(189,630)	
Present value of future minimum lease payments	$ 207,249	

Minimum sublease rentals to be received in the future, which are not included above as offsets to future payments, total $16,186,000 for capital leases and $13,753,000 for operating leases.

Rent expense on operating leases in the years ended December 31, 1986, 1985 and 1984, totaled $137,712,000, $125,261,000 and $105,546,000, including contingent rentals of $10,407,000, $10,022,000 and $9,741,000, but reduced by sublease rentals of $4,004,000, $3,878,000 and $2,865,000. Contingent rent expense on capital leases in the years ended December 31, 1986, 1985 and 1984, was $6,146,000, $5,972,000 and $5,921,000. Contingent rentals are generally based upon sales levels or changes in the Consumer Price Index.

12. Income Taxes:

Provisions for income taxes for the years ended December 31 are as follows:

(Dollars in thousands)	1986	1985	1984
Currently payable (refundable):			
Federal	$33,495	$67,980	$(25,169)
Canadian	2,843	2,107	3,464
State	11,049	2,400	3,026
	47,387	72,487	(18,679)
Deferred (benefit)	(1,887)	(2,771)	30,741
	$45,500	$69,716	$ 12,062

Reconciliations of the Company's effective tax rate and the federal statutory rate for the years ended December 31 are as follows:

	1986	1985	1984
Federal statutory rate	46.0%	46.0%	46.0%
Investment tax credits	(1.6)	(5.5)	(14.7)
State income taxes net of federal income tax benefit	2.4	.5	.9
Depreciation	(9.2)	(12.5)	(20.1)
Earnings taxed as dividends	(6.3)	(3.2)	(4.4)
Capital gains	(13.3)	2.0	—
Other	.5	(2.6)	(.7)
	18.5%	24.7%	7.0%

The provisions for deferred income taxes (benefits) for the years ended December 31 are as follows:

(Dollars in thousands)	1986	1985	1984
Use of accelerated depreciation for tax purposes	$ 26,358	$ 42,529	$37,465
Insurance accruals not deductible for tax purposes	(13,567)	(20,002)	(6,455)
Write-down of inventories to market not deductible for tax purposes	(16,142)	(17,480)	—
Other	1,464	(7,818)	(269)
	$ (1,887)	$ (2,771)	$30,741

Deferred federal income taxes of $52,511,000 and $60,469,000 at December 31, 1986 and 1985, are included in deferred credits and other liabilities. Net deferred tax benefits of $17,434,000 and $15,874,000 at December 31, 1986 and 1985, are included in deposits and prepaid expenses.

On October 22, 1986, the Tax Reform Act of 1986 substantially revised the Internal Revenue Code. While most of the provisions of this Act are not effective until 1987, the investment tax credit provision of the existing law was repealed, subject to certain transition rules, effective January 1, 1986. The effect of the repeal of the investment tax credit provision was to increase income tax expense in 1986 by approximately $8.4 million, of which approximately $7.2 million was related to the first three quarters of 1986.

13. Earnings Per Common Share:

Primary earnings per common share are based on net earnings reduced by preferred stock dividends divided by the average number of shares outstanding during each year. Earnings per share assuming full dilution are based on net earnings divided by the sum of (a) shares used in computing primary earnings per share, (b) average shares issuable upon conversion of preferred stock, (c) shares issuable upon conversion of convertible debentures at the stated conversion rates (related interest requirements eliminated), (d) shares issuable on the exercise of stock options after reduction for shares assumed to have been purchased with the proceeds and (e) average shares issuable under the key employees incentive plan.

14. Segment Information:

Convenience retailing includes all convenience, grocery and auto parts stores, retail gasoline outlets and distribution centers (which derive the majority of their revenues and operating profits from support of these stores). Food processing and manufacturing includes milk, ice cream and other food processing and distribution operations and the ice, Food Labs and Tidel Systems divisions. Interest expense is not allocated to segments. Corporate items reflect revenues, expenses and assets not allocable to segments.

As a result of the sale of half of Citgo's equity, the information previously reported for the gasoline refining and supply segment, which included the Citgo refinery, investments in pipeline companies, a lubricants refinery

and related wholesale, marketing and transportation facilities, has been eliminated. For purposes of this note only, the Profit Sharing contribution attributable to Citgo's operations, which is included in contributions to Profit Sharing on the consolidated statements of earnings, is included in equity in earnings (loss) of Citgo.

Intersegment sales are accounted for on a cost-plus-markup basis. Expenses directly identifiable with a segment and certain allocated income and expenses are used to determine operating profit by segment.

Segment information is as follows:

(Dollars in thousands)	1986	1985	1984
Revenues:			
Convenience retailing	$8,038,591	$8,097,375	$7,592,492
Food processing and manufacturing	870,755	804,956	727,639
Corporate	6,805	6,666	2,704
	8,916,151	8,908,997	8,322,835
Intersegment:			
Food processing and manufacturing	(296,470)	(286,600)	(282,162)
Consolidated revenues	$8,619,681	$8,622,397	$8,040,673
Operating profits:			
Convenience retailing	$ 263,953	$ 259,931	$ 268,240
Food processing and manufacturing	38,203	32,330	29,249
Consolidated operating profits	302,156	292,261	297,489
Interest expense	(59,285)	(57,875)	(57,214)
Corporate expense, net	(56,491)	(55,454)	(42,550)
Equity in earnings (loss) of Citgo	(55,167)	103,319	(25,411)
Gain from sale of half-interest in Citgo	114,732	—	—
Consolidated earnings before income taxes	$ 245,945	$ 282,251	$ 172,314
Identifiable assets at December 31:			
Convenience retailing	$2,311,851	$1,831,712	$1,597,184
Food processing and manufacturing	288,309	195,978	165,776
Investment in and advances to Citgo	286,584	800,904	444,164
Corporate	534,344	404,924	341,923
Total identifiable assets	$3,421,088	$3,233,518	$2,549,047
Capital expenditures:			
Convenience retailing	$ 561,695	$ 327,649	$ 268,528
Food processing and manufacturing	55,369	32,449	25,914
Corporate	169,834	104,756	97,035
Total capital expenditures	$ 786,898	$ 464,854	$ 391,477
Depreciation and amortization expense:			
Convenience retailing	$ 152,103	$ 134,621	$ 121,892
Food processing and manufacturing	18,521	16,040	14,324
Corporate	14,898	12,990	11,662
Total depreciation and amortization expense	$ 185,522	$ 163,651	$ 147,878

15. Related Party Transactions:

Leases with Profit Sharing

During 1984, Profit Sharing purchased 31 7-Eleven or Chief Auto Parts stores from the Company for $13,307,000, which includes the Company's direct and indirect costs. The stores were simultaneously leased to the Company at annual rentals approximating market rates. No stores were purchased during 1986 or 1985. At December 31, 1986, Profit Sharing owned 775 stores leased to the Company under capital leases and 615 stores leased to the Company under operating leases. Included in the financial statements are the following amounts related to these leases:

December 31	1986	1985
(Dollars in thousands)		
Buildings, net of accumulated amortization of $34,112 and $33,028	$26,517	$29,911
Capital lease obligations, net of current portion of $3,128 and $3,000	$34,798	$38,315

Year ended December 31	1986	1985	1984
(Dollars in thousands)			
Rent expense under operating leases and amortization of capital lease assets, included in cost of goods sold	$30,094	$30,256	$29,452
Imputed interest expense on capital lease obligations	$ 3,683	$ 4,080	$ 4,403

Transactions with Citgo

Investment in and advances to Citgo are as follows:

December 31	1986	1985
(Dollars in thousands)		
Interest-bearing advances to Citgo	$100,000	$255,182
Investment in Citgo	186,584	545,722
Investment in and advances to Citgo	$286,584	$800,904

In the normal course of operations, the Company purchases refined products from Citgo and receives reimbursement for administrative services and interest on its advances to Citgo.

The amounts of refined product purchases from Citgo were $954 million, $1.54 billion and $1.16 billion for the years ended December 31, 1986, 1985 and 1984. The decrease during 1986 resulted primarily from a decline in product prices.

In connection with the sale of half of Citgo's equity, the Company entered into a 20-year product purchase agreement with Citgo to buy gasoline at market-related prices. Minimum required annual purchases under this agreement are generally the lesser of 750,000,000 gallons or 35% of gasoline purchased by the Company for retail sale.

The Company has guaranteed certain debt and other obligations of Citgo of approximately $55 million, as well as various contingent obligations of Citgo of approximately $12 million. The Company has also guaranteed the performance of Citgo in certain product purchase and other arrangements and of pipeline affiliates of Citgo in certain throughput agreements. The Company expects Citgo to have the ability to perform under these guaranteed obligations. Any payments the Company would be required to make under the guarantees are indemnified 50% by PDVSA.

16. Quarterly Financial Data (Unaudited):

Summarized quarterly financial data for 1986 and 1985 is as follows:

(Dollars in millions, except per-share data)	First quarter	Second quarter	Third quarter	Fourth quarter	Year
Net sales:					
1986:					
Originally reported	$3,055	$2,932	$2,269	$2,105	$10,361
Citgo adjustment	(1,056)	(727)	—	—	(1,783)
Restated	**1,999**	**2,205**	**2,269**	**2,105**	**8,578**
1985:					
Originally reported	2,800	3,311	3,326	3,282	12,719
Citgo adjustment	(879)	(1,057)	(1,022)	(1,183)	(4,141)
Restated	1,921	2,254	2,304	2,099	8,578
Gross profit:					
1986:					
Originally reported	323	571	541	454	1,889
Citgo adjustment	132	(46)	—	—	86
Restated	**455**	**525**	**541**	**454**	**1,975**
1985:					
Originally reported	407	584	603	472	2,066
Citgo adjustment	(19)	(89)	(81)	(32)	(221)
Restated	388	495	522	440	1,845
Earnings (loss) before income taxes:					
1986	**(107)**	**98**	**219**	**36**	**246**
1985	1	119	125	37	282
Income taxes (benefit):					
1986	**(18)**	**17**	**35**	**12**	**46**
1985	—	30	46	(7)	69
Net earnings (loss):					
1986	**(89)**	**81**	**184**	**24**	**200**
1985	1	89	79	44	213
Primary earnings (loss) per common share:					
1986	**(1.91)**	**1.64**	**3.76**	**.44**	**3.96**
1985	.02	1.88	1.65	.86	4.41
Fully diluted earnings (loss) per common share:					
1986	**(1.91)**	**1.59**	**3.58**	**.44**	**3.91**
1985	.02	1.87	1.63	.85	4.37

The Citgo adjustments reflect the restatement of previously reported quarterly financial data for the change to account for the investment in Citgo on the equity method.

The effective tax rates for the fourth quarters of 1986 and 1985 were 33.4% and (16.7)%, which adjusted income tax expense to the actual annual effective tax rates of 18.5% and 24.7% from the previously estimated effective rates of 16.0% and 31.0%. The fourth quarter 1986 tax rate reflects changes as a result of the Tax Reform Act of 1986 (see Note 12).

The third quarter of 1986 included a $99.7 million pretax gain on the sale of half of Citgo's equity. The fourth quarter of 1986 included the recognition of an additional pretax gain of $3.6 million, primarily representing a portion of the deferred gain on the sale recorded at September 30, 1986.

The fourth quarter of 1985 and the first and second quarters of 1986 included non-cash write-downs to market value of Citgo crude oil and wholesale refined product inventories of $38, $100 and $54 million, pretax, on a FIFO basis for crude oil. During the fourth quarter of 1986, Citgo changed its method of accounting for crude oil from FIFO to LIFO (see Note 1), which increased the 1986 inventory write-downs and Citgo's operating profits by an equal amount, with no effect on net income of Citgo or reported net income of the Company. On a LIFO basis, the write-downs for the first and second quarters of 1986 were $155 million and $67 million, pretax. During the fourth quarter of 1986, Citgo recovered part of the write-downs to market, and the Company realized a recovery of $53 million pretax, or $28 million net of Citgo's income tax effect, representing its equity share of Citgo's recovery.

Board of Directors

John P. Thompson (1948)
Chairman of the Board

Jere W. Thompson (1961)
President and
Chief Executive Officer

William W. Atwell[2] (1976)
Investments

J. Y. Ballard (1937)
Investments

Frank L. Carney[1] (1982)
Owner,
Carney Enterprises

Walton Grayson, III (1962)
Executive Vice President,
Administration and Services

Mark L. Lemmon, M.D.[1] (1977)
Plastic and Reconstructive Surgeon

Leo E. Linbeck, Jr.[1,3] (1982)
Chairman and Chief Executive Officer,
Linbeck Construction Corporation

Clark J. Matthews, II (1981)
Senior Executive Vice President
and Chief Financial Officer

Walter M. Mischer, Jr.[3] (1982)
President,
The Mischer Corporation

Alan C. Schoellkopf[1,2,3] (1979)
Vice President,
Rotan Mosle Inc.

Joe C. (Jodie) Thompson, Jr.[2] (1979)
President,
Sigel Liquor Stores

(Date indicates year first elected)
[1]Members of the Audit Committee
[2]Members of the Nominating Committee
[3]Members of the Compensation and Benefits Committee

Joseph S. Hardin, a former executive vice president, retired from the Board of Directors on May 7, 1986.

Dr. Armand Hammer resigned from the Board of Directors on September 1, 1986, following the sale of Occidental Petroleum Corporation's shares in Southland.

Officers

Senior Officers

John P. Thompson
Chairman of the Board

Jere W. Thompson
President and
Chief Executive Officer

Clark J. Matthews, II
Senior Executive Vice President
and Chief Financial Officer

S. R. Dole
Executive Vice President,
7-Eleven Stores

Walton Grayson, III
Executive Vice President,
Administration and Services

James W. Parker
Executive Vice President,
Manufacturing and Distribution

Operating Officers

Dale H. Allardyce
Vice President, Distribution
(Effective January 28, 1987)

John F. Antioco
Vice President, Marketing — Retail
(Effective October 22, 1986)

Robert E. Bailey
Vice President, Southern Stores Region
(Effective May 7, 1986)

C. O. Beshears
Vice President, Dairies Group

Donald L. Burnside
Vice President, Western Stores Region

Adrian O. Evans
Vice President, Central Stores Region

Kenneth J. Hughes
Vice President, Special Operations

Frank L. Kitchen
Vice President, Eastern Stores Region

Hugh G. Robinson
Vice President, Cityplace Project,
and President, Cityplace
Development Corporation

Richard A. Turchi
Vice President, International Operations

Staff Officers

Frank J. Gangi
Vice President and Treasurer

David Karney
Vice President,
Management Information Services

P. Eugene Pender
Vice President and Controller

L. Mark Rigg
Vice President, Human Resources

John H. Rodgers
Vice President and General Counsel

Kenneth M. Slauth
Vice President, Development

Henry T. Stanley, Jr.
Vice President,
Corporate Communications

R G Smith
Secretary

Corporate Information

Corporate Headquarters:

The Southland Corporation
P.O. Box 719, Dallas, Texas 75221
(214) 828-7011

Shareholder Contacts:

Corporate and Financial Information — write the Investor Relations Department at the above address, or telephone (214) 828-7217.

Shareholder Services (Shareholder account, dividend reinvestment or other shareholder services) — write the Corporate Secretary at the above address, or telephone (214) 828-7300.

Annual Meeting:

The Annual Meeting of the Company will be held at 10 a.m. Wednesday, May 13, 1987, in the North Wing Auditorium of the Corporate Office, 2828 North Haskell Avenue, Dallas, Texas. All shareholders are cordially invited to attend.

Securities Listed:

New York Stock Exchange:
- Common Stock (SLC)*
- $4.00 Cumulative Convertible Exchangeable Preferred Stock, Series A
- 8⅜% Sinking Fund Debentures
- 9⅜% Sinking Fund Debentures
- 9½% Sinking Fund Debentures

Pacific Stock Exchange:
- Common Stock (SLC)*

Luxembourg Stock Exchange:
- 5% Convertible Subordinated Debentures
- 12% Canadian Notes
- 7⅞% Cityplace Center East Corporation Notes

**Includes rights to purchase Junior Participating Preferred Stock, Series B*

Transfer Agent and Registrar:

(For securities listed on the New York Stock Exchange)

MBank Dallas, N.A.
P.O. Box 225415
Dallas, TX 75265
Dallas: 749-5941
Texas: (800) 492-9734
Outside Texas: (800) 527-7844

Auditors:

Touche Ross & Co.
2001 Bryan Tower, Suite 2400
Dallas, TX 75201

Dividend Reinvestment Plan:

This plan provides a simple, convenient and inexpensive way for shareholders to invest cash dividends and additional cash deposits in Southland stock. For further information, please write the Corporate Secretary at the Corporate Headquarters address.

Form 10-K:

Shareholders may obtain a copy, exclusive of exhibits, of the Form 10-K Annual Report for the year ended December 31, 1986, as filed with the Securities and Exchange Commission, by writing to the Investor Relations Department at the Corporate Headquarters address.

Market Data:

Southland's common stock is traded under the symbol SLC on the New York, Pacific, Boston and Philadelphia Stock Exchanges. The following price/earnings ratios are based upon primary earnings per share for the four preceding quarters.

Quarters	Price Range		Price/ Earnings Ratios	
	High	Low	High	Low
1986				
First	50	40⅜	11.3	9.2
Second	56⅜	44⅞	22.7	18.1
Third	56⅞	45¼	25.4	20.2
Fourth	60½	45⅛	13.9	10.4
1985				
First	33½	24¾	9.8	7.3
Second	37⅜	28¾	11.9	9.2
Third	39½	33⅝	10.5	8.9
Fourth	50	35⅝	11.9	8.5
1984				
First	35¾	31	11.0	9.6
Second	36½	26⅝	11.0	8.0
Third	32⅞	23	9.0	6.3
Fourth	32¾	25	9.6	7.4

Southland Facilities

Convenience Retailing

7-Eleven	7,672
Other Retail:	
Quik Mart, Super-7	163
Chief Auto Parts	465
High's Dairy Stores*	346
Total Units	8,646
International Affiliates:	
Sweden: 7-Eleven	68
Mexico: Super Siete	61
Total Affiliate Units	129
7-Eleven Area Licensees:	
United States	494
International	3,479
Total Licensee Units	3,973
Total Retail Units	12,748
Distribution Centers	5
Chief Auto Parts Warehouses	2

Food Processing and Manufacturing

Dairies:	
Processing Plants	28
Distribution Points	62
Food Centers	6
Snack Food Plants	2
Reddy Ice Plants	9
Food Labs Plants	3
Tidel Systems Plant	1

Citgo Facilities

Citgo Refinery	1
Cit-Con Lubricants Refinery**	1
Lubricants Compounding/ Packaging Plant	1
Refined Product Terminals**	39
Pipelines (miles):**	
Crude Oil Gathering	7,512
Refined Product	7,982

Facility numbers as of December 31, 1986
**Acquired December 30, 1986*
***Various ownership interests*

The Southland Corporation P.O. Box 719, Dallas, Texas 7522